The Saudi Financial System

In the Context Of Western and Islamic Finance

by

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Preface

The fulfillment of economic and social development plans in the Kingdom of Saudi Arabia is made possible through a financial system which channels government revenues through public and private financial institutions. This financial system, which is relatively unstructured and unknown, especially to students and researchers in the field of international finance, has been influenced by Western and Islamic financial theories, markets and institutions. Accordingly, the basic purpose of this textbook is to detail and discuss some of the most significant aspects of the emerging Saudi financial system.

The book is divided into three major parts. The first part of the book introduces the major factors in the evolution of the Saudi Financial System, environmental and institutional. The second part encompasses four chapters, 2, 3, 4 and 5, and deals with the money and capital market institutions and system in which the evolution of the Saudi financial system is taking place. Chapter 2 covers Saudi monetary policy, its development, activity, tools and objectives. Chapter 3 covers the commercial banking system, possibly the main instrument of change in the financial system. Chapter 4 details the activities and performance of the offshore banking units, Saudi international banking and other money market institutions which have performed a major role in the external and traditional money flows in the Kingdom. Chapter 5 provides an analysis of capital market activity in the Saudi financial system and a discussion of some specific implications and conclusions.

The third part of the book provides details on Islamic financial institutions and their implications and their influences on the Saudi financial system. This part includes three chapters, 6, 7 and 8. Chapter 6 covers the theoretical and organizational developments of Islamic banks and their relationships to the Saudi financial system. Chapter 7 covers the investment methods and banking and social services of Islamic banks. Chapter 8 provides an assessment of past performances and the prospects for Islamic banking.

This book is intended for a one-semester course in Saudi finance for advanced undergraduate and graduate students majoring in business administration or finance. Students and businessmen in international business may also find this textbook useful.

Review and discussion questions are included at the end of each chapter to provide students and other interested readers with a tool for comprehensive review and understanding of the materials covered.

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PART I

INTRODUCTION

CHAPTER 1

Evolution of the Saudi Financial System

Saudi Arabia, one of the least understood Middle Eastern economies, but potentially one of the most dynamic, presents a collage of environments to students of economic development. The kingdom's relative isolation from the West has resulted in little available effective knowledge of its economic base. However, its roles as the possessor of the world's largest proven oil reserves, the largest foreign exchange reserves, and possibly the most ambitious development plans ever undertaken, rank it as a significant world economic power.[1]

This book will consider various aspects of Saudi financial development and attempt to place them in perspective for comparison with both present world financial systems and to discuss the international role and impact of Saudi financial institutions. The format of the book is designed to give meaning to detail the process of growth and development in the Saudi financial system. Thus, it is necessary to characterize the theoretical framework behind institutional growth. This requires consideration of the historical evolutionary process behind the development of the system, how it has become a 'system', where the system is changing, as well as present operations, achievements, and prospects for the future. In addition, there is a need to look at some of the major social, cultural, and legal factors behind the development process. After this review it will be possible to understand clearly the various institutional factors currently evolving in both the public and private sectors in Saudi Arabia and to study the changing functions and roles in the financial system. In this connection, it is relevant also to observe the emerging new financial concept of Islamic financial institutions.

The discussion opens with a review of the kingdom's physical and administrative features. The first chapter continues with a discussion of the development framework in Saudi Arabia, the five-year development plans, and the financial results achieved thus far by the development plans.

GENERAL PHYSICAL AND ADMINISTRATIVE FEATURES

Geographical Factors

Occupying approximately four fifths of the Arabian Penninsula, Saudi Arabia is surrounded by Kuwait, Iraq, and Jordan to the north, by the United Arab Emirates, Qatar, and the Arabian Gulf to the east, Oman, North Yemen, and South Yemen to the south, and the Red Sea to the west. Saudi Arabia's land mass of 865 000 square miles is divided into four major provinces:

(1) Asir in the southwest, about 40 000 square miles;
(2) Najd in the central plateau area, approximately 650 000 square miles;
(3) Hejaz in the northwest, about 135 000 square miles;
(4) Al Hassa in the east, about 40 000 square miles.[2]

The kingdom's topographical features are diverse, beginning with the narrow coastal plain along the Red Sea. A north–south chain of mountains slightly in from the coast separates the coastal plain from a great plateau which slopes gradually to the eastern coast on the Arabian Gulf. As a result of the different elevations in the country, the range of climates and temperatures is significant. The coastal areas tend to be humid in the summer, with moderate (50–80 °F) winters. The mountain areas in general are cool all the year round, with the central plains hot and dry in the summer, and cooler – down to freezing in the areas 5000 feet and above – during the winter months.

There are no rivers or forests in the arid climate of Saudi Arabia, but there are a number of scattered oases. Rainfall ranges from 3 to 4 inches per annum in most parts of the country, but it is as high as 13 inches in the Asir region of the southwest. As a result, irrigation, based on underground water and various dam projects, is required to maintain and expand agricultural development.[3]

Political and Administrative Structure

The kingdom's monarchical system, which emerged by royal decree in 1932, incorporated all the provinces of the kingdom under King Abdul Aziz Ibn Saud and his successors. Based on the principles of Muslim Shariah (Islamic Law) as set forth in the Holy Qur'an and the Sunnah (the Prophet's sayings and deeds), the governmental process emanates from the king's royal decrees, which are issued on the advice of the Council of Ministers.[4]

The government administrative process is highly centralized in the capital city of Riyadh. Local and regional governmental units normally handle internal security problems and administration of the municipalities, with the central government combining legislative, judicial, and executive functions, through the king, the crown prince, and the Council of Ministers. To administer the decisions of the central government there are 20 ministries. There is also a group of advisory planning organizations which form a consultative council and a group of judicial, theological and law interpretation and educational institutions.[5]

Provincial governmental operations are administered through princes (*amirs*) who handle local security and administrative matters. Below the province level there are districts and population centers which are administered through lower ranking princes. The province princes are responsible to the central government through the minister of the interior and are chosen by the central government. Each level of provincial administration also has an elected advisory council to aid and advise the administrative head.[6]

Resources and Population

The cultivated area of Saudi Arabia is small, approximately 1.3 million acres, only a fraction of the total area of the country. However, oil and mineral resources are abundant, with proven crude oil reserves estimated at 116.7 billion (i.e. thousand million) barrels at the end of 1981, over 25 percent of the world total. The production of natural gas and derivative by-products is becoming a major recent development. With the completion in the early 1980s of the Government Gas Program, the world's largest engineering project, Saudi Arabia will become a major supplier of natural gas products (3 billion standard cubic feet per day of 'wet' gas) and itself a major user through its extensive petrochemical facilities on the east and west coasts of the kingdom.[7]

There is, however, mineral wealth beyond oil, with substantial unexploited deposits of gold, silver, copper, lead, iron, zinc, chromium, tungsten, titanium, and lithium. There are also exploitable amounts of flourite, limestone, clay, phosphate, manganese, asbestos, pyrites, and gypsum.[8] Considerable time and money are already being expended on this potential in order to provide an alternative source of income when the flow of oil slows and becomes less important in the country's national economy.

The kingdom's population is a major variable which presents a negative factor in the drive towards economic diversification and financial development. Manning the institutions of recent and future economic development will require a relatively large labor force. Most official population estimates indicate a range from 7.0 to 8.6 million, with the expatriate population approximately 1.5 million. Within the Saudi population there could be as many as 5.5 million settled people and 1.6 million nomadic and semi-settled people in the desert and on the fringes of the cities. However, with recent estimates of population growth among Saudis ranging between 3.0 percent and 3.7 percent per year, a very high rate, the potential for the future looks promising.[9]

The urban population of the kingdom is beginning to perform an increasingly important role in the economy. Several factors, including urban income potential and the number of new households being formed in urban areas, are critical in this analysis. Since 1974 natural growth and immigration have increased the population of the kingdom by about 25 percent; and migration to towns and cities has raised the settled population by around 15 percent.[10] In major cities, the average household size has dropped by approximately 13 percent, and accordingly the number of household formations is increasing rapidly. These

changes are probably in response to incentives presented by work opportunities in the cities and the liberal lending policies of the Real Estate Development Fund, which makes home construction loans to any married Saudi male over 18 or unmarried Saudi male over 21.[11]

Another major factor in the kingdom's economic development process is the rate at which the Saudi workforce is being prepared to assume effective responsibility for control of the economy. The critical constraint in the economic diversification effort is the lack of trained Saudis to fill positions that will be created as industrialization occurs. While the situation is improving, the deficit of Saudi nationals entering the workforce is not being substantially reduced. Two major factors in the situation are:

(1) The economy is expanding rapidly and creating jobs at unprecedented rates relative to the small numbers of Saudi nationals participating in the commercial/industrial sectors of the economy.
(2) The education system is expanding, and more young people are going to school and staying there longer.[12]

The anticipated Saudi manpower drought of the 1980s and 1990s will create special problems for the rapidly industrializing sectors of the economy. This period will see the birth and development of hundreds of firms which eventually will form the nucleus of an industrial base. These companies, however, will have to cope with a serious difficulty. While controlling costs and product quality, often in the established international marketplace, these firms must compete for Saudi nationals not only among themselves but also with the government and with educational institutions.[13]

Social and Cultural Considerations

Another critical aspect affecting financial institutional development in Saudi Arabia is the problem related to transferring Middle Eastern social and cultural values into a set of Western financial and economic development precepts. For example, the Middle Eastern emphasis on the value of the individual within the family unit can delay the movement towards Western-style banking. The main social and economic unit in the Middle East has been, and still is, the family, as property owner, employment exchange, social security, and financial broker, compared to the depersonalization of the Western financial system. While this factor is changing with the development process, it still performs a crucial and effective role which compares in significance with the role of religion, because Islam sets the patterns of behavior in religious as well as secular matters, with rights and duties well-defined by the Qur'an. These factors have been and can continue to provide major constraints in the adaptation of Western economic development methods and institutions.[14]

The conflict with the Western model also carries into the intellectual sphere. Western economic considerations call for questioning, a spirit of rationality, personal mobility, and a strong motivation for individual gain which is not

greatly influenced by family and religion. Also, individual enterprise and private ownership are not established according to social status but rather are based on individual ability and fitness for the job. This all fits in with Joseph Schumpeter's theme of 'the perennial gale of destruction' as a motive for change for its own sake and the basis for effective economic progress and growth.[15]

Another point of obvious conflict with Islam relates to the Islamic prohibition of interest and secularization of business.[16] While there are indications of possible resolution on these points, some matters, such as the employment of women in certain economic sectors, still are basically untouched. Attempts to restate Islam to accommodate it to Western ideas of progress and economic development have been widely and strongly opposed in the Middle East, and the uncompromising Islamic philosophy regarding the pattern of life as a whole will probably separate the two systems for some time to come. The problem basically is one of adaptation of modern and successfully proven Western economic and financial methods and techniques to a Middle Eastern developing economy that has strict moral, religious, and social values.

ECONOMIC PLANNING AND DEVELOPMENT IN SAUDI ARABIA

The Five Year Development Plans

Three Five-Year Development Plans[17] are behind the kingdom's ambitious drive for economic growth and diversification. The activities and spending patterns in the plans have been increasingly sophisticated, based originally on rather general development goals but now placing considerable emphasis on specific economic sectors. The First Five-Year Development Plan contained numerous general economic and social goals along with policies, programs, and projects to achieve these goals. One important goal was to increase the role of the non-oil sectors of the economy and accordingly decrease the relative impact of the oil sector. This has been an elusive goal, and the Saudi Arabian government has steadfastly maintained that the non-oil economy is growing. Summaries of the results of the three five-year plans indicate that during the first plan the average annual compound growth in the Gross Domestic Product was 13.41 percent, in 1969–1970 constant prices, based on an average annual compound growth rate of 14.80 percent for the oil sector and 11.66 percent for the non-oil sector. During the Second Five-Year Development Plan period the economy experienced an 8.04 percent average annual compound growth rate: 15.13 percent for the non-oil economy and 4.78 percent for the oil sector. The third plan proceeded one step further with a planned average annual compound growth of 3.28 percent overall: 6.19 percent for the non-oil economy and only 1.34 percent for the oil sector.[18]

While infrastructure, economic resources, human resources, and social resources development received the major development emphasis in the First

Table 1.1 Five year plans/revenues and expenditures (billion Saudi riyals)

	First plan 1970–1975		*Second plan 1975–1980*		*Third plan 1980–1985*	
Sector	*Plan*	*%*	*Plan*	*%*	*Plan*	*%*
Development						
Infrastructure	12.05	29.16	114.54	23.00	249.10	21.99
Economic resources	2.69	6.51	89.64	18.00	261.80	23.11
Human resources	7.38	17.86	79.68	16.00	129.60	11.44
Social resources	1.92	4.65	34.86	7.00	61.20	5.40
Sub-total	24.04	58.18	318.72	64.00	701.70	61.95
Other						
Defense	9.56	23.14	79.68	16.00	350.00	30.90
Aids, loans, subsidies			64.74	13.00	49.60	4.38
Administration	7.72	18.68	34.86	7.00	31.40	2.77
Sub-total	17.28	41.82	179.28	36.00	431.00	38.05
Total plan	41.32	100.00	498.00	100.00	1132.70	100.00

Sources: Compiled Saudi Arabian Monetary Agency Annual Report 1400 (1980), p. 27; Third five-year development plan, 1400–1405 A.H. – 1980–1985 (Riyadh, 1981), pp. 19–21, 88–96; 'New budget to spend SR 260 billion,' *Arab News*, April 4, 1985.

Five-Year Development Plan (58.18 percent), allocations to defence and administration also received high priority (41.82 percent), reflecting the fact that the plan was drawn in a period of fiscal restraint and that the Saudi economy was only beginning to prepare for industrial development and diversification. However, the unanticipated expansion in crude oil production and per barrel revenues between 1971 and 1975 contributed to a dramatic increase in development potential. The Second Five-Year Development Plan increased the emphasis on infrastructure, economic resources, human resources, and social resources development to 64 percent of the total while defense, aids, loans, subsidies, and administration were 36 percent of the total. During the second development plan oil revenues continued to increase and economic activity and budget allocations also increased. This situation temporarily delayed the effort to reduce dependence on the oil sector and encouraged additional infrastructure plans far too ambitious for the economy to absorb effectively. As a result, huge shortages and inflation occurred between 1975 and 1977, placing additional stress on achieving financial and fiscal reforms. The Third Five-Year Development Plan was intended to bring about major financial and fiscal reforms, to complete the infrastructure developments, and to begin serious economic diversification. Economic and human resource developments, therefore, received a substantial absolute increase, to 62 percent of the total, and while the defence budget was not announced, estimates were that it would be approximately 350 billion Saudi riyals (SR), bringing the

Table 1.2 Revenue and expenditure ratios (Billion SR)

	First plan	*Second plan*	*Third plan**
(A) Actual revenues	176	719	1379
(B) Actual expenditures	78	688	1166
(C) Planned expenditures	41	498	1133
Ratio of planned expenditures to actual revenues (*C/A*)	23%	69%	82%
Ratio of actual expenditures to planned expenditures (*B/C*)	190%	138%	103%

Sources: Compiled from Saudi Arabian Monetary Agency Statistical Summary 1402 (1982), p. 25; Third five-year development plan, 1400–1405 A.H. – 1980–1985 (Riyadh, 1981), pp. 19–21, 88–96; "New budget to spend SR 260 billion," *Arab News*, April 4, 1983.

* Based on plan and budgeted actuals for the first three years of the plan, and planned for the final two years.

total of defense, aids, loans, subsidies, and administration to 38 percent of the total.

Analysis of the revenue and expenditure ratios for the three development plans provides additional perspective on the direction of the development of the economy and financial system in Saudi Arabia. During the first development plan, planned expenditures were SR 41 billion, only 23 percent of actual revenues, but actual expenditures were 190 percent of planned expenditures, an indication that despite the tremendous increase in oil revenue the government was able to expand its manpower and organizational resources to cope with these increases, a remarkable accomplishment. The second plan called for planned expenditures of SR 498 billion compared to the SR 41 billion planned in the first development plan. It is noteworthy that the ability of the economy to implement and absorb considerable increases in infrastructure spending indicates the potential for future organization of financial institutions and systems. During the second development plan actual expenditures again were substantially higher than those called for by the plan, primarily in response to the urgent need to end various bottlenecks in infrastructure and distribution systems. The main emphasis was on development of physical infrastructure facilities (ports, housing, roads, airports, and community services) in the kingdom to remove the constraints hampering growth in the economy. Thus, during the second plan, and into the third plan, the government increasingly recognized and acted on the need to expand output in the economy.

Achieving high expenditure rates in Saudi Arabia during the late 1970s was a significant accomplishment because total government expenditures during the first development plan, as shown in Table 1.2, were only SR 78 billion, with expenditures during the first year of the second plan exceeding expenditures during the entire 5-year period of the first plan. During the second plan period (1975–1980), actual government revenues were estimated at SR 719 billion

compared to actual expenditures of SR 688 billion. On an annual basis, the gap between expenditures and revenues narrowed, so that during the last 2 years of the second development plan expenditures almost matched revenues. For example, expenditures overran revenues by about SR 13 billion during the fourth year of the plan, with the deficit met by transfers of funds from state general reserves.[18]

The third development plan (1980–1985) began the shift away from the infrastructure sector of the economy, which involved mainly construction activities, to the productive sectors of the economy, with concentration on industry and modern agriculture. The third plan, as viewed by the key planners, was a critical period in which the labor force would be taught the skills required if the full economic benefits of the expansion of the industrial sector were to be secured. Thus, the third plan addressed the need to increase investment in the development of human resources through maximum utilization of the existing labor force and increased emphasis on manpower training. This, in turn, was expected to lead to higher productivity and increases in both the Gross Domestic Product and the average income of the labor force.[19]

Specific emphasis during the third plan period was placed on:

(1) Reducing the relative economic weight of the oil sector.
(2) Encouragement of import-substitution industry, with the main emphasis on movement away from the production of construction materials to light industries.
(3) Development of increased joint foreign participation in industrial development which would transfer technology to Saudi Arabia and its citizens.
(4) Achieving maximum effectiveness in manpower, training, housing, and industrial development efforts to eliminate the imbalances between regions in terms of amount of investment and per capita income.
(5) Completion of the infrastructure activities carried over from the second plan, using government funds to complete huge industrial complexes at Jubail and Yanbu, and selling the complexes back to the people at cost as they begin generating profits.[21]

In sum, the Third Five-Year Development Plan has initiated the process of integrating the infrastructure and economic diversification efforts in order to achieve a self-sustaining economy for the kingdom's present residents and future generations.

Government Revenues and Expenditures

Since Saudi Arabia derives most of its revenues from the sale of crude oil, there are few sources of non-oil related revenues at present. Non-oil revenue sources, however, are expected to grow rapidly during the latter years of the third development plan as some of the export-oriented primary industries begin operations, providing the grist for many future financial developments. Currently, revenues generated from various government duties and fees, sale

of government services and property, rents, Zakat (the Islamic religious tax), pilgrimage, and non-oil exports make up approximately 5 to 15 percent of total revenue.[22] In addition, revenues from government investments overseas have increased significantly over the past few years, from approximately SR 14.6 billion in 1978 to about SR 24.8 billion in 1980.[23]

Actual spending exceeded planned expenditures by 90 percent during the First Five-Year Development Plan and by 38 percent during the second plan. For both plans, actual expenditures were less than government revenues, with expenditures accounting for 44 percent of revenues in the first plan and increasing to over 95 percent of revenues during the second plan.[24] Due to the decline in oil revenues, actual third plan expenditures may not exceed planned spending, providing both a base for increased economic stability, and a reduction in the potential inflation caused by spending which has in the past exceeded the absorptive capacity of the economy.[25] The accumulation of a large surplus revenue in previous years will necessitate the continued diversion of funds to the international money markets with some financial risk associated with the erosion of real value due to inflation.

Revenue limitations have not constrained government spending during the last 10 years, and even the 1982–1983 slowdown in oil demand has not severely affected spending patterns. A comparison of total revenue levels during the three five-year development plans indicates that there was a four-fold increase between the first and second plans, and the third plan could show an increase of more than two-fold over the second plan, despite an assumption of an average production rate of only 5.0 million barrels per day, a 2.0 to 3.0 percent 'real' annual increase in price over the plan period. The sheer magnitude of these increases and the changing direction of government development plan expenditures are and will be important variables in the development of private sector finance.

It is envisioned that the government's fiscal policy will attempt to optimize surplus revenue levels by keeping actual spending close to revenue levels while maintaining a single-digit inflation level, which at times may require a downward shift in crude production levels in order to lower revenues. Depending on the revenue assumptions used, the level of actual spending could remain stable. Table 1.2 shows expenditures increasing almost two-fold during the third plan compared to an expenditure increase of almost nine-fold between the first and second plans.

The most significant aspect of development assistance to the private sector is the allocated expenditures directly infused into or through the financial system. The Third Five-Year Development Plan projected allocated expenditures of approximately SR 702 billion for the development sectors, including infrastructure, human and economic resources development, and social development, but excluding expenditure requirements for defense, internal security, and foreign aid. Compared with approximate second plan development expenditures of SR 319 billion, the third plan development allocations of SR 702 billion represent a substantial increase. However, during the second plan

period the government fiscal budgets revised allocations downwards to 50 percent of the total budgeted spending. The second plan spending reallocations indicate the potential for significantly lower expenditures on development in the third plan fiscal budgets, reducing the expected growth of private sector financial activity.

Specific spending priorities in the third plan, which will have considerable impact on the expansion of national financial and monetary policy and private sector industiral and financial system development, include a wide variety of projects which will further enhance the absorptive capacity of the economy. These projects include continued development of the ports, housing, airports, telecommunications and road networks, municipalities, industries, electricity, desalination, education and training, and health and social welfare facilities. The success of housing construction in the private sector, and the resulting lessening of the housing crunch of the 1975–1977 period, has been one of the more important contributions by the government to the private sector. While the individual loans provided by the government have eliminated the need for more high-rise rush housing schemes, the public housing program will continue, with low-rise villa construction and accelerated distribution of free plots of land to needy citizens.[26] However, the almost total government financial support of the housing programs effectively removes the banking system from involvement in this important financing activity, which can be important in monetizing and making liquid the debt and growth of the economy.

In airport, port, telecommunications and road construction the government has performed a significant role in not only aiding general development but helping to improve the general communications and product flow which is closely tied to the financial system. Airport construction will gain momentum during the third plan. The construction of two new international airports, in Riyadh and Dhahran, and 23 additional airports distributed throughout the kingdom, will continue. The targets for telecommunication and road network expansion also have significance for the financial sector, both from communications and business development perspectives, with plans for 1.2 million additional telephones and 28 000 kilometers of roads. Port expansion has been an important sector during the two preceding plans, but it is beginning to wind down and emphasis is shifting to more effective and efficient use of existing facilities.[27]

The mass migration of rural people to urban areas also is the focus of considerable government spending, in the development of secondary towns and small villages and continued improvements in the larger municipalities.[28] It is also of concern in the development of the branch banking system which is required in the growth of the banking system and for the continued monetization of the economy.

The industrial sector will receive the largest increase in spending during the third plan. This is in line with the government's desire to effect a shift towards productive investments which would help diversify revenue sources. Industrial estates are receiving continued financial support throughout the kingdom to

foster light industry to compete against imports.[29] In addition, the Saudi Arabian Basic Industries Corporation (SABIC) and Petromin, the kingdom's petroleum refining and marketing organization, which began funding industrial development during the second development plan, will devote major efforts to the establishment of export-oriented heavy industry in Jubail and Yanbu.[30] The growth of this sector naturally is of great significance in the expansion of the financial and banking services system, and while there was little effective progress in the second plan period, there has been remarkable development since the third plan got underway in mid-1980.

An area related to industrial development, electricity, is also receiving a big boost in expenditures, with planned additions of approximately 15 000 megawatts to the existing 4000–6000 megawatts. The desalination program will continue the construction of the major desalination plants started during the second plan and will begin constructing 29 additional plants with combined electricity output of almost 2000 megawatts.[31] The drinking water capacities for the major population centres also will be expanded significantly, and 37 new dams will be built to reclaim additional land for agriculture.[32]

One of the major problems in the development and expansion of the financial system is a shortage of trained Saudi managers in all economic sectors. The third plan places very high priority on education and training to prepare the Saudi population for more active participation in the development of the country. Even though complete Saudization of the labor force may be difficult to achieve, the third plan will limit the growth of the expatriate labor force, making the replacement of foreign workers by Saudi citizens a priority objective. The planned spending for all phases of the education program is the largest single expenditure item for the third plan. The kingdom's universities will continue their expansion programs,[33] and 375 additional intermediate and secondary schools will be built between 1980 and 1985.[34] The combination of these two programs will increase significantly the coverage of the education program and assist in achieving the overall third plan manpower and Saudization objectives.

The development plans of the kingdom not only are technically complex but also require considerable organizational and institutional activity. The financial aspects are difficult to coordinate due to the mix of national and international technical and commercial arrangements that must be made. An effectively operating financial system is required to assist in the implementation of national financial plans and public finance goals and arrangements. This is one of the most important activities for the financial system in Saudi Arabia, and it should be expected that in the coming years private sector finance will perform a growing role in this activity.

ECONOMIC AND INSTITUTIONAL PRECEPTS FOR THE SAUDI FINANCIAL SYSTEM

The Saudi financial system has evolved from a number of sources, but primarily

it is an eclectic marriage of Western and Islamic institutions. Consequently, an evaluation of the system requires consideration of the central economic concepts which are behind Saudi Arabian national development. The concepts stressed here are economic development and interest.

Economic Development

Analysis of the major Western economic development and growth concepts is relevant for understanding the Saudi financial institutions which have evolved over the last several decades in Saudi Arabia. Development is, however, a difficult concept to place in a standard analytical framework. Development is a concept so often couched in terms of industrial and trade statistics that economists often fail to focus on the broader aspects of the growth process. Financial system institutional development is to a large extent responsible for economic growth. In the Middle East, and especially in Saudi Arabia, the flow of income and funds has become almost rampant in the last few years, placing a tremendous burden on the existing financial institutional system but at the same time opening the way for numerous development opportunities. Since most Middle Eastern nations basically are oriented today towards some variety of capitalism, it is necessary to begin any study of growth in the region's financial system with a consideration of the theory framework and actual results of its Western capitalistic predecessors.

It should be noted that in countries with a non-monetized or limited cash economy, where hoarding gold and silver is common, the need for an efficient financial institutional system is essential. A strong central monetary authority, with the means of exerting discretionary power over the monetary and banking system, is required to increase monetization and to ensure price stability.[35] As a consequence, investigation of the sources of financial system development and the actual growth process is important.

The most significant Western economic development theories detailing the role of financial institutions in economic development have been provided by Western economists, especially Joseph Schumpeter, Joseph Spengler, W. W. Rostow, J. M. Keynes, Gunnar Myrdal, and Irma Adelmen. Schumpeter and Keynes were proponents of the theories related to the use of 'created' bank credit as a means of effecting necessary financial expansion and as a vehicle for economic expansion. While their ideas were applied primarily to various economic recovery and demand creation problems in the developed economies, they also have become important in the modern theories which view banking as a very signficant actor, as opposed to a passive observer, in the development process.[36]

Schumpeter, Rostow, Keynes, Spengler, Myrdal, Adelmen, and other theorists have, in attempting to relate monetary and development theory to the role of financial institutions, focused on bank activity in capital formation and in the trade cycle. Classical economists viewed credit as a form of savings originating in abstinence, with primary deposits the main concern. As a result, derivative deposits were not included as a basic means for generating capital development, and savings were viewed as the essence of capital accumulation. This view changed as Schumpeter, writing in the early twentieth century, recognized the role for bank credit in capital formation. Schumpeter pointed out, however, that for any of this process to have meaning there must be banks and financial institutions developed and ready to take advantage of the opportunity.[37]

Schumpeter's view that banking and bank activities helped to expand production through creation of greater purchasing power and larger money incomes is critical in many ways for economic growth in Saudi Arabia. The kingdom and other developing areas require considerable shifts in resource application because trade and commercial activities dominate the business process. It is significant that as banks have emerged in the Middle East they have been oriented towards short-term finance and credit activities, and effective future industrial-type growth requires a totally different orientation. Further, the entrepreneurial framework has to change to accommodate new type of thinking and business procedures. The primary considerations are: (1) the question of the capability of Middle Eastern entrepreneurs to employ thousands of people in one organization in an efficient and effective manner, and (2) the lack of an impartial legal framework to accommodate depersonalized economic growth.[38]

Another major factor in the economic growth process and the creation of an effective financial system is the presence of a strong central bank. Early attempts to develop a central bank in most developing nations resulted only in effecting a superimposition on the existing commerce and trade-oriented banking structure. Often the banks were colonial-based institutions which in the past specialized in export–import trade unrelated to the new development goals established in the post World War II period. In these situations specialized government credit institutions and money lenders have performed an important role.[39]

Further complicating the problem is the fact that Middle Eastern financial institutions have in the past demonstrated limited flexibility in investment and credit policies. The central bank, for example, had to cope with tradition along with the pressure of large government development spending activities which are tied to the limited local production capacity and generally insufficient supply elasticity in the economy. The problem thus is not only to create a sound banking system and to re-orient old banking practices but also to cope with another major problem in achieving economic stability, accomplishment of a high and steady rate of growth in the economy.[40]

Saudi Arabia's recent economic and financial development is creating a base for the kingdom's emerging role in the international financial system. Much research has been devoted to detailing the many facets of the income side of the economic growth process in the kingdom, but there has been almost no effort applied to analysis of the recent significant expansion in the Saudi financial system, its institutions and its instruments.

Interest

The interest concept presents a significant obstacle to effective financial integration and cooperation between the Western and Islamic systems. Interest performs a prominent role in Western economic and banking development, but in Islam interest is strictly prohibited. Further, Islamic literature makes no distinction between usury and interest, referring to both as *riba* (forbidden), because interest rates fluctuate over time, and what is considered as moderate and reasonable today may be considered excessive tomorrow.

In biblical times interest on money was considered to be usury. Usury was forbidden between Jews[41] but not for aliens who borrowed money from Jews to develop trade. Generally, the Christian rules relating to interest, as well as to loans, were tied to spiritual rather than economic aspects of society. The interpretation was that interest was usury and therefore forbidden because a greater value was taken from the borrower than was given, resulting in an injustice to the borrower. This view prevailed into the fourteenth century but was modified later in order to accommodate industrial and exchange development. Buyers on credit, discounts on bills of exchange, partnerships combining money with labor, and other related dealings gradually were allowed as the influence of the Church declined and the individualism of Protestantism rose.

In modern times the theory of interest has been a weak link in economic theory, with Western economists alternately claiming that interest is the key to economic development because of the role it performs in stimulating savings and productive investment, and that it is the cause of many of society's economic ills including prolonged recession, inflation, high unemployment, social unrest, economic instability, and even wars.

Several stages in the philosophical development of the interest concept took place during the eighteenth, nineteenth, and early twentieth centuries. The French Physiocrats, led by Jacques Turgot, began the process by distinguishing between money and capital, with savings as the source of capital.[42] Turgot argued that the productivity of capital and abundance of capital were necessary for all enterprise and that low money interest rates were both the cause and index of abundant capital.[43]

Classical economists, including Adam Smith and David Ricardo, contended that interest was the compensation which borrowers paid lenders for the profit made by use of the borrowed capital. Smith adopted the position that interest was the reward or inducement paid for utilizing savings, and that employing capital in production resulted in an increased value of the product over the labor value. Ricardo, on the other hand, attributed all value to labor. Other classical economists adopted variant positions. Nassau William Senior, for example, believed that interest was the price paid for abstinence. Alfred Marshall substituted 'waiting' for abstinence as a justification for interest on the supply side of the process,[44] with the demand for capital and the ability to pay interest dependent on the marginal productivity of the capital. Thus, a basis of classical economic theory was that the rate of interest brought about

equality between savings and investment, but if savings were in excess of investment the rate of interest would decline and investment would be stimulated to the point of equality.

John Maynard Keynes developed the first serious commentary and criticism of the classical interest theories by pointing out that savings were not determined by interest, with the proof found in the fact that in modern society the majority of savings were effected and mobilized as a result of corporate activity and bank credit creation rather than individual efforts. Keynes found the level of income rather than the rate of interest the means to achieve equality, meaning that savings would increase with a rise in aggregate income. Consequently, higher interest rates would provide a negative inducement to invest, effecting a drop in output and employment. Keynes viewed the interest rate as a psychological phenomenon because 'its actual value is largely governed by the prevalent view as to what its value is expected to be'.[45]

Some modern economic theorists do not accept the classical, Keynesian or Neo-Keynesian theory framework. The basis for the refutation has been established by Milton Friedman and other so-called monetarists who have attacked Keynesian programs to maintain full employment with deficit spending and continual expansion of the central bank balance sheet through purchases of government securities. They have argued that such activities naturally lead to price inflation and provide negative factors in the economic growth process.[46]

HISTORICAL INSTITUTIONAL DEVELOPMENT

As was noted earlier, in order to place the development of the Saudi financial system in perspective it is necessary to consider the historical development of the institutions which have provided the basis for the current Saudi institutions and the system generally. There are two basic historical institutional development frameworks which have had an impact on the kingdom's institutions: Islamic and Western. Each source gives the Saudi system a number of basic philosophical and technical precepts which are being woven into a unique whole. This is constantly evolving towards a stronger system. The previous section, on interest, indicated one critical variable. The following material provides another adjunct, the specific tradition that has been blended with the Saudi economy to create the aspects now considered unique. In addition, it is clear that thus far the kingdom has been able to isolate and often eliminate the least beneficial aspects of each precedent system and permit market forces to mollify such aspects to create a stronger entity for the future.

Islamic Financial Institutions

The subject of financial administration and regulation of the economy during the reign of Islam has not been given full treatment by historians and contemporary scholars, due largely to the structured complexity of the Islamic

state institutions for financial administration. The subject of Islamic institutions is, however, relevant to the discussion of present financial systems in Saudi Arabia and other Muslim countries since certain current practices and institutions are derived from this heritage.

Two prominent features of historic Islamic financial institutions are the prohibition of interest and the imposition of the Islamic religious tax, Zakat. Starting in the seventh century, Islam abolished the practice of usury and the system of taxation used by the Persians, Romans, and Byzantines. Both activities were considered unfair practices that led to economic and social ills and unrest. The prohibition on receiving or paying any kind of fixed rate on borrowed money was a basic factor in the departure from prior economic thinking. The Zakat was imposed on wealth and income and collected basically from the rich, with a distribution to the poor and other specified categories of individuals requiring such assistance. In addition to the Zakat the Islamic state had other sources of revenue such as Sadakat (charitable gifts), war booty, taxes levied on land (Khardj), and taxes levied on non-Muslims in lieu of military service (Djizya).

To administer the operations of the state during the rule of the caliphs, the Umayyad state, and the Abbasid state, several innovative and sophisticated administrative and financial institutions were formed. These institutions included several organizations to finance wars, to provide pensions for the military and civil servants and to supply food and clothes for widows, orphans, and state prisoners. These highly organized, diversified, and specialized institutions were charged with the regulation and administration of the economic activities of the state. One important administrative or financial institution was the Diwan, which is equivalent to a modern government department or ministry. The Diwans formed a complete system, with financial instruments, techniques, and regulations that dealt with welfare, revenue, expense, accounting and auditing activities. Each Diwan had branches in the provinces which served as field offices where taxes were assessed and collected, necessary administrative expenses made, books kept, regulations and rules enforced, and audit and control functions performed. The system resulted in the creation of a central bank (Diwan Al-Djahbadha or the Imperial Bank) that aided the operations of the flourishing economy, regulated the flow of money and conducted other financial activities similar to those performed by modern central banks. The old silver and barter standard of exchange was replaced by a new standard based on gold and money currency. This change encouraged the state to adopt universal standards and regulations and these were administered by the central imperial state bank in order to regulate the flow of currency and supervise its stability.

State revenues and expenditures were controlled by Diwan Bayt Al-Mal (State Treasury), which was analogous to a modern ministry of finance. The Diwan Bayt Al-Mal was the controlling authority between Diwan Al-Nafakat (Department of Expenditure) and Diwan Al-Usal (Department of the Interior). All orders for expenditure issued by Diwan Al-Nafakat required the countersignature of the Secretary of Bayt Al-Mal. The Diwan Bayt Al-Mal controlled the categories of expenditures according to the instructions and restrictions stated in the Qur'an. Certain tax revenues had to be spent on specific expenditure categories. Branch offices of Bayt Al-Mal in the provinces were ordered to send any balance left to the main office of Bayt Al-Mal after payments for administration, state annuities, and the salaries of civil and military personnel had been made. There were other Diwans which had a direct relationship with Diwan Bayt Al-Mal, such as Diwan Al-Birr Wa Al Sadakat (Department of Charity), which collected Zakat and Sadakat, Diwan Al-Ata (Department of Payments and Pensions) which paid pensions to the troops out of war booty, and Diwan Al-Kharaj (Revenue Department) which collected all taxes other than those collected by Diwan Al-Birr and deposited them in Diwan Bayt Al-Mal.

The financial instruments used to facilitate collection and transmission of revenues and payment of expenditures include Suftadja, Hawala, and Sakk. Suftadja was a promissory note or draft used by tax collectors to transmit revenues. The Hawala was a bill of exchange used to transmit money through the bank in a fashion similar to money orders used by modern post offices or banks. The Sakk was a check introduced by the Imperial Bank to remit funds from one area to another through its branches in the provinces. These financial instruments led to a credit economy, with the state advancing huge sums of money through the Imperial Bank to finance commercial activities, benefiting not only the state but also individual citizens who were able to obtain credit from the bank free of any interest charges.[47]

Two basic features of the Islamic financial system thus were the extension of credit without interest and the collection and payment of Zakat and other taxes in accordance with the provisions of the Qur'an. Because of the historical importance of the Zakat institution it is essential to explain briefly its meaning, extent, scope, and role in Islamic economic and social wellbeing. Literally, Zakat means purification – purifying wealth of its evil tendency to gather more and more in fewer hands on account of unequal opportunities. Through the state, Zakat provided a source of revenue which was used to provide the basic necessities of life for all members of the nation. Zakat was designed to make wealthy individuals alive to, and responsible for solving, the problem of poverty. The distribution of surplus wealth to the needy achieved social as well as economic goals. The distribution of Zakat to needy persons also created purchasing power to stimulate the economy. The state was required to ensure that the necessities of life were provided for all its people in order to assist them to become efficient and to provide them with employment in order to raise the standard of living.[48]

Historically, Zakat was levied on the total net worth of each person's property. It was due on all types of wealth, including the income added during the year. Wealth included property possessed and fully owned by a person, including debts and claims which were expected to be received. Zakat was leviable on things which have the capacity to grow and add to the wealth of the

individual, provided that the addition is set aside for the production of further wealth. Examples of productive wealth include gold and silver, pastured animals, and property intended for trade. For each kind of wealth there was a minimum tax exemption limit called Nisab which referred to the amount of wealth which exceeded the amount needed for subsistence and primary necessities of life for the person and his family. This requirement was in line with the main purpose of Zakat which was the assurance of social justice through assistance of the needy, the elimination of concentrated wealth in the hands of the few, and the encouragement of investment to improve the economy and provide employment.[49]

Zakat was obligatory on net worth and not on total wealth. Examples included hoarded wealth which lay unused for the year, the excess of annual earnings over annual expenditures which was not invested in the business and which remained with the owner for more than one year. After deducting Nisab and debt, all idle wealth was taxed at the rate of 2.5 percent. Mines and treasure-troves were taxed at the rate of 20 percent. In the case of mines, Zakat applied whether the mines were owned by the individual or by the state. Agricultural products were taxed at the rate of 5 percent if the land was irrigated by the labor and capital of the cultivators, and at the rate of 10 percent if the land was irrigated either by rain or free of charge by canals built by the government. Herds of cattle were subject to a capital tax varying between 1 percent and 2.5 percent. Trade capital (merchandise) was taxed at the rate of 2.5 percent.[50]

The revenue from Zakat had to be spent on certain categories of expenditures clearly stated in the Qur'an. In brief, Zakat funds could be spent on two categories of individuals. The first group included those who were in significant need of funds such as the poor, indigent, debtors who incurred debt for their own needs, and wayfarers. The second group included people who could be either poor or rich such as the administrators of the Zakat fund, debtors who incurred debts to benefit others, and those who worked for the cause of God.

The Islamic system of finance was rigid as far as the Zakat and other Shariah taxes were concerned, but it was open to the introduction of new taxes, provided the circumstances warranted a change. Tax increases also had to be imposed as a temporary measure to meet certain needs or emergencies and were withdrawn as soon as the emergency was over.[51] This flexibility is demonstrated in many Islamic countries today. In addition to the Zakat tax, many Islamic countries impose other kinds of direct and indirect taxes as the economic and social circumstances require. In Saudi Arabia, for example, taxes on the incomes of oil companies and other companies and individuals constitute a major source of revenue, but the total Zakat tax is quite insignificant in comparison (about 1 Zakat to 1000 income tax in 1977/1978). Taxes on personal income were abolished in 1975, and the incomes of Saudi companies, whether in industry or trade, are fully exempted from company taxes (except the Zakat tax). Foreign companies pay low income taxes (25 to 45 percent) and are entitled to liberal tax exemptions if they have Saudi partners. Substantial

increases in oil revenues from royalties effected these exemptions; however, the Zakat tax is still levied on all Saudi citizens and Saudi companies, along with the Saudi interest in foreign companies and joint ventures. In addition, all citizens of the Gulf States of Qatar, Kuwait, and Bahrain who own property and are engaged in commercial and industrial activities in Saudi Arabia are required to pay the Zakat tax.

The historically prominent features of the Islamic financial system will exist in Saudi Arabia. The Zakat tax is still assessed, collected, and spent in accordance with the Islamic Shariah. The Zakat tax system is regulated by a royal decree issued in 1950 and administered according to Ministry of Finance directives. The other prominent feature of the Islamic financial system, the extension of loans free of interest, is still practised by the Saudi government. Interest-free loans are granted by the specialized credit agencies for the purpose of developing several segments of the economy including industry, housing, and construction. Money lending by commercial banks, however, is often subject to interest charges, a feature that reduces the Islamic influence on the Saudi financial system as a whole. This feature has caused many Muslims in Saudi Arabia and other Muslim countries to refrain from keeping their savings in commercial banks because *riba*, or interest, is banned by the Islamic Shariah and because it involves accepting fixed gains without sharing the risks entailed in productive enterprise. This situation has caused many small savers in the Muslim world to turn to the Islamic banks in the Middle East, Asia and Africa. The growth rate of these banks has been impressive despite the fact that the saving accounts do not pay any interest and do not carry any guarantee against loss. The status of Islamic banks in Saudi Arabia, and their relationship to the Western-oriented financial institutions, will be explained in a succeeding chapter.

In conclusion, the present Saudi financial system has deep Islamic roots. The system since the time of the Prophet has been simple and has created for the agriculture, trade, and hajj sectors of the economy. However, with the increase in economic, social, and development activities, the system has become more complex. The size of individual business units has increased, new technologies have been introduced, and allocation of the country's vast oil resources requires careful economic and social planning. New financial institutions, markets, and instruments have been introduced, and interaction with Western systems is necessary for introducing efficient and modern practices and techniques. Meeting these complexities and yet keeping the Islamic character and heritage of the country is a challenge that faces all Saudis who are affected by or who are connected with the financial system, whether they are government officials, business owners, managers, banking executives or private citizens.

Western Financial Institutions

The economic history of the Western capitalistic nations since the Industrial

Revolution has seen the growth of banking facilities and financial instruments to respond to various economic and financial needs. During the years between the beginning of the Industrial Revolution and 1848, population growth and a general increase in the demand for goods led to considerable bank and currency expansion. Following this phase of development, between 1848 and 1873, there was an era of large capital outlay for the railways and then a decrease in the supply of goods due to the diversion of productive activity as a result of the wars in Europe and the United States. Large-scale overseas production, and the growth in ocean shipping, brought another period where the supply of goods exceeded demand, causing an upsurge in the velocity of money circulation. In sum, the volume of money in circulation, the increase in commercial transactions, along with later rounds of protectionism, were major factors in the various phases of development of banking and financial systems.[52]

During the twentieth century, the growth in banking and financial systems in the Western capitalistic nations has been as significant as in the earlier period. These nations have struggled with the inflation partially engendered by two world wars, and with problems relating to accepting or rejecting the gold standard and international economic cooperation. Central banks and key international and commercial banks performed critical roles in establishing the basis for effective national and international economic growth.[53] Each nation found in this process a financial system which effectively responded to its unique needs. The lines of growth and development have been easily distinguishable, with the relationship between the banking system, industry, and government the critical determinant.

On the European continent, for example, industrial operations were the centers for capital formation, and the main bank interest was in heavy industries which required considerable capital formation. In France this factor was especially significant, with the famed Crédit Mobilier building railways, drilling mines, erecting factories and building canals, ports, and cities. Here the banks were engaging in far more than purely commercial banking functions. They were financing the government and foreign exchange, and floating public securities.[54] As a result, in France and Germany a 'universal' type bank emerged, combining short-term commercial bank activities with the long-term financing efforts of merchant banks.

In Germany there was a further expansion of this concept, with the banks entering into specialized industrial financing and eventually moving into actual ownership in the industry. This merger between financial and entrepreneurial activity also aided in the evolution of the industrial consortium concept. The latter concept worked in conjunction with the investment banking approach where a syndicate of investment banks publicly floated industrial issues and cooperated to extend funds to the industries requiring them.[55] These developments of 'finance capitalism' also occurred in Belgium, Switzerland, Austria, Czechoslovakia, Sweden, and the United States, providing a banking precedent readily available for transfer into other development economies.

In Russia, where both domestic capital and confidence in the banking system were extremely scarce, the banks had to turn to the state for what capital funds they did obtain. Of course, with few funds available for industrial development there was little of the long-term lending activity so necessary for industrial expansion. As a result, the state had to step in to redirect capital from consumption to investment. Eventually, despite government domination of the banking and capital investment process, capital accumulation occurred to provide a long-term capital base as in German practice.[56]

State-sponsored industrialization in centrally planned economies, such as the Russian economy, was necessitated by the relative social and economic retardation and the lack of significant entrepreneurial ability in the various organizations required for economic development. It is possible to identify similar approaches in many developing countries, but in Saudi Arabia, where the capital is available, the process needs only to be started for the next stage to commence. It is only a matter of determining which way the process will head, whether it be *laissez faire* or state control. The answer will depend on many factors, including the banking system, its stage of evolution, and local economic conditions.

Another totally different type of banking system concept has been inculcated into the Saudi system from Great Britain. Here the process of growth and change was more gradual, primarily because the accumulation of earnings in trade and agriculture provided a base for the economic take-off. Further, British bankers have long held an attitude of non-interference in industry, a feeling no doubt aided by the fact that the accumulations of the original promoters of industry were used as the source of capital. And the existing London capital market, which was well organized, made possible lower-cost borrowing, with the joint stock banks involved only in short-term, seasonal, and day-to-day industrial needs. Lastly, the British banks operated on a very thin capital base, making long-term loans a very impractical business venture.[57]

On the European continent there was no well-developed long-term bond market to lead the bankers into participation, control, and eventual ownership of various industries. Thus, it is possible to conclude that the question of availability of short-term versus long-term capital is dependent on local conditions. Because the British had a well-organized financial system and a well-developed capital market prior to industrialization, the banks played a much less important role than on the Continent where industrialization came later. As a result, there was not an efficient capital market on the Continent to provide long-term capital, and the banking system virtually was forced to step in to assist in development. In this fashion the combination of a good opportunity to help and the possibility of profit drew the banks into the capital markets.[58] Thus, while entrepreneurial ability is a critical requirement in any growth environment, potential bank assistance is a must for effective industrial development.

In the United States financial institutional development took an equally eclectic path, with corporate financing activity playing as important a role in

banking growth as it did in continental Europe, but with the government providing only occasional critical incentives for money and capital market development.

The growth of the financial system in the US centered on several major institutional aspects which differed from the European experience. Due to the variety of economic systems which evolved in the states of the Union, banking progress was relatively slow. Early in American history individual states provided legislation enabling chartered banking companies to print and back their own currency, and the federal government provided no paper currency. Gradually, however, the federal government acquired the authority, legal and political, to develop a national banking system which unified currency and deposit rules and capabilities. Through several iterations in the nineteenth and early twentieth centuries, the national banking system evolved.[59]

The financial system wavered between the extremes of free banking, which permitted the states to charter any bank that met very minimal reserve requirements, and the establishment of a tough federal central bank. In this development phase the banking system was characterized by mismanagement and corruption.[60] A war, a major recession, and the great depression enabled the passage of three important pieces of federal legislation which brought the financial system to its present state.

Following the free banking and state control era of the 1840s and 1850s, the National Bank Act was passed during the Civil War. This act authorized the establishment of nationally chartered banks, to be approved and regulated by a federal comptroller of the currency. This system enabled the national banks to issue a new form of national paper currency and taxed the issuance of notes issued by the state chartered banks.[61] Thus, while it provided more control over the banking system, and concentrated control of the circulating currency in the hands of the federal government, a number of monetary control and policy problems remained, especially the lack of a lender of last resort.[62]

The present structure of the US banking system basically was developed through the Federal Reserve Act of 1913. This Act provided an elastic currency, to afford the means of rediscounting commercial paper and to establish a more effective supervision of banking. The Federal Reserve Act also required that all national banks join the Federal Reserve System, and it used the concept of differing reserves for member banks in cities of different sizes, specifying that the required reserves be kept on deposit in district Federal Reserve banks. Finally, the Act gave the Federal Reserve Board the power to alter the Federal Reserve discount rate for loans to member banks.

The development of effective monetary control policies in the United States basically was completed with the passage of the Banking Act of 1933 (Glass-Steagal Act). This Act organized the Federal Deposit Insurance Corporation and extended the open-market activities of the Federal Reserve Board. The open-market function enabled the board to prevent excessive speculation on credit by establishing margin requirements on the purchase of securities and ceilings on interest payable on savings accounts. The Banking Act of 1933 also

permitted branch banking and widened the membership of the Federal Reserve System to include savings and industrial banks.[63]

The other side of the financial system equation in the US was the development of the security exchanges and the gradual emergence of international dollar exchange. As a result of the need to expand the credit base, the incorporation laws were changed to accommodate new economic growth and various financial intermediaries, including life insurance companies and savings banks. These organizations gradually emerged to aid monetary and credit growth and to create the basis for money and capital markets. The major factors behind this expansion were population growth and the effects of war in increasing the demand for goods.[64]

During the late nineteenth and early twentieth centuries the US banking system gradually paid off the foreign indebtedness which had financed growth before the Civil War and allowed the development of the investment banking system. These factors, along with currency stability, encouraged the banks to become involved directly in the industrial merger operations of the 1873–1900 period, allowing them increasingly to influence corporate decision making through involvement in or membership of various boards of directors.[65]

With the creation of an effective central bank and lender of last resort the federal government provided an institution which could direct the money and capital markets to effect a balance in the financial system, if necessary. As American industrial corporations increasingly applied their profits to satisfaction of their capital needs at home and abroad, and as the European countries borrowed to prosecute the wars, the largest firms diversified into activities traditionally dominated by commercial banks, especially in non-bank financial intermediary activities. Meanwhile, the government, through the Treasury Department, performed an increasingly larger role, during World War I and the depression, in directing credit operations to respond to specific development needs.[66]

Relating this development to that which occurred in Saudi Arabia, the close link between financial institutional banking development and industrial growth through various development stages is evident in the Middle East. In Europe and the USA the link evolved from a purely private commercial system to a mixed public and private system, with the helpful role of the national government adding a critical last step. Likewise, in Saudi Arabia and other developing countries, banking started as strictly commercial, but the government had to enter the fray at some point in order to ensure continuity in the industrial and developmental growth process. The role of the government basically has been only complementary to the banking system. While this is due somewhat to the lack of a significant entrepreneurial class, and the small amount of funds in the hands of willing investors, it also is due in the Middle East and Saudi Arabia to the fact that the government, not private entrepreneurs, has been the primary repository of the nation's liquid capital from the international sale of the area's main resource.

The banking and financial system in Saudi Arabia has derived its character,

eclectically, from American and European institutional development, with critical underpinnings from Islamic economic precepts. Initial consideration will be given to the input from Continental, British and US banking and financial institutions. While the evolution of the Western capitalistic financial system has moved in relative harmony since the beginning of the Industrial Revolution in the 1770s, there were several key time frames during which the financial system received significant direction from economic and social circumstances. It may be expected that similar processes have occurred in the past and may occur in the future in the kingdom of Saudi Arabia.

DISCUSSION QUESTIONS

1.1 Identify and briefly describe four environmental factors which influence Saudi financial development.
1.2 When the flow of oil income slows, what other potential sources of income may be exploited in Saudi Arabia?
1.3 What are some of the negative factors which face Saudi economic diversification and financial development? Discuss.
1.4 What are the Western social and cultural factors that seem to conflict most with Saudi economic development methods and institutions? Discuss.
1.5 The three Saudi five-year development plans emphasized different goals. Identify these goals and state the circumstances that led to their earlier-than-planned accomplishment or caused their delay.
1.6 Why and how do the Saudi government planned and actual expenditures affect growth and inflation? Discuss.
1.7 Diversion of Saudi surplus funds to the international market is associated with financial risk. Why?
1.8 The most important contribution by the Saudi government to private sector development in the 1975–1977 period was in financing housing developments. Why? To what extent was the banking system involved in this activity?
1.9 How does the Saudi government plan to diversify revenue sources?
1.10 Certain Western economic development and growth concepts were discussed in this chapter. Analyze these relevant concepts in terms of their relationship to the Saudi economy.
1.11 Discuss the development of historical and modern theories of interest.
1.12 What are the two basic historical institutional developments which have had an impact on Saudi financial institutions? Discuss.
1.13 What are the basic features of the historical Islamic financial system? Cite examples of financial institutions, instruments, and regulations that exist today in the Saudi financial system.
1.14 Explain the meaning, extent, scope, and role of Zakat in the Islamic economic and social well being.

1.15 Why is interest prohibited by the Islamic Shariah? What are the consequences of the prohibition of interest on economic development?

1.16 The Islamic concept of interest seems to be the major obstacle to cooperation and interaction with efficient and modern Western financial practices. Do you agree? Why?

1.17 What are the Western banking system concepts that have been inculcated into the Saudi financial system? Discuss.

1.18 Some observers suggest that the role of the entrepreneurial class in the development of the Saudi financial system is not significant. Do you agree? Why?

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PART II

MONEY AND CAPITAL MARKETS

CHAPTER 2

Monetary Authority and Control

In the past the achievement of a strong financial system has required exceptional monetary authority and control mechanisms. Even a country with considerable monetary resources is not free of this requirement. Monetary authority and control in the kingdom of Saudi Arabia has been successful while other Middle Eastern countries have experienced problems in this area. The Saudi Arabian Monetary Agency (SAMA) is one of the most powerful and unique monetary authorities in the world despite the fact that it has very few direct means at its disposal to regulate the banking system. In addition to reviewing SAMA's development and the kingdom's banking regulations, this chapter considers monetary activity options that SAMA implements in its unique style of financial and economic policy development. After reviewing several policy considerations and options available in Saudi Arabia, the chapter provides a detailed analysis of monetary activity.

The Saudi Arabian monetary system began to emerge less than 30 years ago. As a result, the analytical database for evaluation of the monetary authority and control system is relatively limited. Prior to the 1950s the money supply was composed almost entirely of full-bodied coin, and the state income was simply expensed by the government without any formal accounting controls. The financial system essentially emanated from Jiddah, the center for the yearly hajj traffic and business contact with the West.[1] While this system evolved in line with the direction of trade, it did not provide the basis for continued economic development activity for other sectors and regions of the kingdom.

An understanding of the Saudi monetary system requires an evaluation of the roles and functions it serves or should serve, as well as an account of the evolution of the system. As a reference point, in Saudi Arabia, as in the West, the roles and functions of the financial system may be portrayed in terms of long-term development goals which could include:

(1) helping to monetize the economy in order to facilitate capital formation;
(2) promoting general efficiency in the economic system;
(3) responding to credit needs which shift with long-term development;

(4) promoting economic stability;
(5) effecting transactional and operational efficiencies;
(6) aiding in the channelling of income towards productive investments;
(7) developing or aiding in the evolution of necessary financial intermediaries.[2]

Since there are many differences between the developed and developing economies in the long-run economic growth process, some of the purposes and roles of Saudi financial institutions are substantially different from Western institutions in the long run. Over the short run, however, the development goals basically are the same. For this reason comparisons with and utilization of Western experience should be rewarding. For example, the process of movement from a money and short-term credit (trade and commerce) orientation towards banking and other financial activities which will aid the growth of an effective central bank and financial markets, should be similar to the Western experience. In both developing and developed economies the objectives as to achieve economic progress and the capability to respond effectively to changing world trade and resource patterns.

SAUDI ARABIAN MONETARY AGENCY

History and Overall Role

In the early 1950s increased oil revenues provided a unique opportunity for the Saudi government to accelerate long-term improvement in the kingdom's international balance of payments. The government at the same time realized the need to introduce fiscal and monetary reforms to hasten economic growth and development. The first important step in this direction was the establishment of a central bank. Royal Decree No. 30/4/1046, dated 20 April 1952, established a rudimentary central bank, the Saudi Arabian Monetary Agency (SAMA).

SAMA was founded in conjunction with plans drawn up by US Federal Reserve Board experts who, under Point Four Program auspices, visited the kingdom in 1951. SAMA's original financial objectives were to monitor government expenditures and regulate the commercial banks, but a larger objective was to achieve stabilization of the riyal, the basic Saudi monetary currency unit, along with control of the kingdom's monetary assets including precious metals and bank reserves.

SAMA had little effective power over the financial system for a number of years because the 1950s were an era of relatively loose fiscal controls, with the government virtually bankrupt at times, and the 1960s were an era of reform in the monetary system. Most of the major monetary and financial activities in the 1950s were in conjunction with maintaining a balance between oil revenues and government expenditures. In the 1960s SAMA's role was expanded to provide a higher level of fiscal control and prevent a repeat of the situation which occurred during the 1950s. The major controls included establishing and maintaining asset and loan limits and monitoring general commercial bank operations, primarily transaction service charges.[3]

SAMA today is responsible for all development in the kingdom's financial system. The agency's charter has been revised and its powers have been expanded several times. As a result, SAMA now possesses the ability to perform the general functions of a modern central bank, and it has made an important contribution by encouraging diverse commercial banking development and promoting agricultural and industrial progress.

SAMA has pursued a neutral monetary policy by allowing private demand for credit to find its own level. However, SAMA and officials of the Ministry of Finance and National Economy have endeavored to maintain close supervision of the commercial banks as a means of ensuring an orderly development of the banking system. In a related area, SAMA recently has begun to assume a more positive role in its responsibility for control over the kingdom's foreign assets. Lastly, SAMA acts as an interbank clearing house, administering the policies which prescribe statutory reserve requirements, basic liquidity quotas, and margins for the establishment of letters of credit.[4]

Since its foundation SAMA activities have been directed by the Ministry of Finance and National Economy. Despite the fact that the royal decree establishing SAMA did not specify the extent of the agency's powers, its primary monetary activity responsibilities were limited to the following:

(1) stabilizing the internal and external values of the Saudi riyal;
(2) selling gold and silver for the government account;
(3) holding the country's monetary reserves;
(4) assisting the Ministry of Finance and National Economy in holding the government's expenditures within the annual budget;
(5) regulating the commercial banks;[5]

Establishment of SAMA was a turning point in the financial history of the nation because central banks in general, and in the developing countries in particular, provide an indispensable and efficient monetary mechanism for the steady utilization of the national resources and the means to increase the standard of living. The central bank also fosters a flow of money and credit to facilitate orderly economic growth, a stable currency, and long-run improvement in the nation's international balance of payments.

Development Responsibilities

In most countries the central bank acts as the chief monetary authority and lender of last resort, lending money to banks overnight or for longer periods when they are unable to borrow funds elsewhere. The potential of the lender-of-last-resort function provides a certain degree of stability to the banking system. The central bank usually has the power to restrain the commercial banks in their loan operations, raising or lowering discount rates as needed to

restrict or loosen credit. This ability provides a major leverage factor for a central bank, and is one of the most important of all banking functions.[6]

The central bank also serves normally as the administrator of monetary affairs, controlling the level of interest rates and thereby influencing the pace of economic growth of the nation. This is accomplished by adjusting reserve requirements, which effectively reduces or increases borrowing rates, and by conducting open-market operations through the sale of government securities which decreases or increases the money supply since the money used to pay for the securities is drawn out of the system. There is no government debt in Saudi Arabia, a fact which eliminates the possibility of open-market operations. Consequently, SAMA is limited to exploiting reserve requirement regulations. This is effectively a negative rather than a positive regulatory activity since the regulations are directed at controls on the financial system as opposed to financial and economic development efforts. The agency primarily has determined what cannot be done rather than informed them what SAMA and the banks should be doing, together, to aid the development of the country. While the commercial banking system generally has been content with SAMA operating in a passive monetary role, there have been several monetary adjustment problems which have demonstrated the need for a stronger central bank.

One of the basic causes of the problems which have led to the need for possible restructuring of SAMA's operational framework is the original charter, which prohibits SAMA from performing the following:

(1) granting loans to the government or private individuals;
(2) taking or giving interest;
(3) issuing paper currency and departing from the Qur'anic injunction that exchanges will involve only items of equal value.'

Despite royal decrees approved in 1957 and 1959 which have modified somewhat the restrictions on private sector and government loans and the issuance of paper currency, the problem of operating an efficient financial system within these and other basic restrictions has persisted.

The governor of SAMA and the board of directors, as provided in the charter, have been entrusted with the day-to-day operations and administration of the agency. However, the nomination and appointment of both the governor and the members of the board of directors rest with the minister of finance and national economy and the Council of Ministers. The agency also is required to present monthly reports of its operations to the government through the Ministry of Finance. In addition, SAMA is subject to audits by auditors appointed by the government. The charter of the agency specifically describes its functions, which have been divided into (1) currency affairs, (2) functions performed as a fiscal agent for the government, and (3) economic and financial research.

First, as part of its currency affairs function, SAMA's foremost concern is to stabilize and maintain the external and internal value of the riyal. The inflow of oil revenues, particularly important since the 1973 oil price increases, has

significantly affected the value of the riyal. Also, for the last few years the value of the riyal has remained pegged, officially, at SR 4.50 per dollar even though its actual value has been lower. The specific charter currency responsibilities, as defined in Royal Decree No. 23, 15 December 1957, cited in Appendix A, include:

(1) To buy and sell gold and foreign exchange in the market.
(2) To hold and operate any monetary reserve funds as separate funds earmarked for monetary purposes only.
(3) To mint and issue the Saudi coins and handle all matters relating thereto, in conformity with Saudi Currency Law No. 24.

Among the other currency affairs responsibilities held by SAMA is regulation of the commercial banks and money exchangers. When SAMA was established, the extent of its control over the commercial banks was not clearly specified. To correct the situation, Article 16 of the Banking Control Law of 1966 specified SAMA's commercial bank responsibilities, which may be summarized as follows:

'The [Monetary] Agency may, with the approval of the Minister of Finance and National Economy, issue general rules regarding the following matters:

(1) The maximum limits of total loans that can be extended by a bank or banks.
(2) The prohibition or limitation of specified categories of loans or other transactions.
(3) Fixing the terms and conditions which banks should take into consideration when carrying out certain types of transactions for their customers.
(4) The cash margins to be obtained by banks against specified categories of credits or guarantees.
(5) The minimum ratio to be observed between the limits for loans and the collateral for such loans.
(6) Fixing the assets to be maintained by each bank within the kingdom. Such assets should not fall below a certain percentage of the bank's deposit liabilities which shall be fixed by the agency from time to time.'[8]

Fiscal activities are the second important area of SAMA responsibility. The agency is authorized to receive and act as depository for all revenues, including receipts from concessionnaire companies, customs, hajj, and other sources. SAMA maintains deposit accounts for government agencies and other designated organizations through and under the direction of the minister of finance and national economy. The agency also acts as the agent of the government in paying out funds for purposes duly approved by the government, through the minister of finance and national economy.

SAMA's third major function is economic research which will enable it to advise the government on various economic issues and perform a key role in economic policy making. To this end the agency gathers, classifies, and analyzes monetary, exchange rate, and bank activity data to assist the government in formulating and carrying out financial and economic policies, which in

turn will aid economic development and growth. In the absence of the interest rate mechanism the only major research activity relates to the money supply, and as a consequence there is little additional research which could be considered developmental in the normal Western central bank context. Since this activity thus far has not been fully developed, SAMA at present provides only selected reports and other publications.

SAMA clearly has acted along very narrow lines of authority, and there is considerable rationale for this practice. The agency is responsible for a large share of the kingdom's financial assets required to promote future diversification of the economy, a burden which requires agency and Ministry of Finance officials to act prudently. Estimates of the kingdom's foreign assets, largely controlled by SAMA, range from $70 billion to $130 billion. Estimates made prior to the 1981–1983 world economic slowdown indicated that the Saudi investment surplus could reach $200 billion by 1985. The decline in oil production and prices which began in 1982 should considerably modify the surplus forecast.

Most of the foreign surplus administered by SAMA is invested in short-term government and other highly liquid money market instruments which would be readily available on call for national development purposes. Even though there were some private loan investments in blue chip US companies such as IBM, AT&T, and Dow Chemical, the overall SAMA investment strategy has been to reduce risk to an absolute minimum. There has been some tendency to diversify the investment portfolio, with rumors of some medium- and longer-term bond placements in Japan and in countries with balance of payments problems, but the potential for a shift in the investment diversification effort is substantial given the worldwide economic and political destabilization occurring in the early 1980s.[9]

Banking Regulation

The banking system in Saudi Arabia is a reflection of the conservative social environment, with SAMA strictly applying the various rules and policies it is required to administer. While there are housekeeping regulations, such as opening hours, it is in the application of the operating rules that SAMA's input is significant. The Banking Control Law of 1966 (see Appendix B), administered by SAMA, provides the basic framework for development of the banking sector, but also one of the points of controversy for the banking community. Recent changes in the Saudi and world economic environments are dictating potential major changes in the Banking Control Law.

Among the controls where SAMA has the greatest impact is credit availability. Article 7 of the Banking Control Law calls for the banks to place a statutory deposit of 15 percent of capital and reserves, interest-free, with SAMA, limiting bank credit expansion. Within the general requirements of Article 7, the banks find considerable SAMA control over their reserves. SAMA may vary the deposit requirements between 10.0 percent and 17.5 percent, if it

considers a change to be in the public interest. Deposit requirements may be altered only with approval from the minister of finance and national economy. An additional constraint in Article 7 on liquid reserves gives SAMA an almost punitive control over the assets of the banks: 'Every bank shall maintain with the Agency at all times a statutory deposit of a sum not less that fifteen percent of its deposit liabilities. . . .' While this requirement exists in other Middle Eastern and in Western countries, it is two to three times the percentage imposed on banks in the Western countries. Thus, liquidity is required to be kept at a fairly high level, usually 15–20 percent of deposits, and the exact rates vary according to SAMA rulings. The rate for demand deposits was reduced from 15 percent in 1979 to 7 percent in 1981, while time deposit rates were lowered from 7 percent in 1979 to 2 percent in 1981.

In addition to the reserve and liquidity requirements, Articles 6 and 8 of the Banking Control Law are the areas of main concern. Article 6 requires that if the deposit liabilities of a bank exceed fifteen times its reserves and its paid-up capital, the bank either must increase its capital and reserves to the prescribed limit, as approved by SAMA, or deposit 50 percent of the excess deposits with SAMA at no interest. Bankers feel that this is an unduly restrictive penalty for being successful at drawing deposits and therefore it should be modified. In practice, this rule has led the banks to transfer excess deposits offshore, mainly to Bahrain.

Article 8 of the Banking Control Law, which also has drawn considerable fire, prohibits loans to any one individual or organization that exceed 25 percent of the bank's reserves and paid-up capital. SAMA may, in the public interest, and subject to such conditions as it may impose, increase this percentage to up to 50 percent. This regulation effects limits on the maximum size of the loans available to a single customer. These provisions are also applicable to letters of credit and guarantees, and bankers argue that the article effectively limits economic growth and development in the country. Individual contracts, which often exceed several hundred million riyals, cannot be covered in the kingdom because the guarantee can easily be in excess of 25 percent of the bank's capital and reserves. The result is that the banking community is frequently placed in a very tight situation, and is forced to handle many guarantees offshore. Consequently, bankers would like to see the 25 percent limit lifted, at least on letters of credit and guarantees.

SAMA restrictions also direct that banks cannot make loans to foreigners except to corporations approved by SAMA. Further, banks must, according to Article 13, put aside 25 percent of their net profits to build up their reserves. This special reserve accumulates until the amount of the reserve equals a minimum of the bank's paid-up capital, providing the banks with the major means of increasing their equity base. SAMA has been very reticent to permit increases in paid-up capital, which is equal to authorized capital in all the original Saudized banks. SAMA also levies a 45 percent tax on interest and dividends paid to the foreign bank shareowners. This is the equivalent of the withholding tax utilized in many developed countries. In this and other areas of

the Banking Control Law of 1966 changes have been suggested which would reflect the economic conditions existing in the country and would enable the banks to serve their customers more effectively, and in turn also strengthen the banking industry in the long term.

MONETARY POLICY

General Indicators of Monetary Policy

An appropriate indicator is needed for implementation of an effective monetary policy, usually either the interest rate or the quantity of money. Through the economic history of most developed countries the interest rate has been the major guideline in establishing and carrying out monetary policy. Only recently has greater emphasis been placed on the quantity of money as the major and most appropriate indicator.[10]

In Saudi Arabia, the interest rate is not and cannot be the major indicator of monetary policy. Since the interest concept is considered contradictory to Islamic teaching, it is generally accepted that SAMA cannot deal with interest and should not act in any manner which conflicts with the teachings of Islamic Law; and, as indicated in the SAMA Charter, 'the Saudi Arabian Monetary Agency shall not pay nor receive interest but shall only charge certain fees on services rendered to the public and to the Government, . . .'

SAMA has not used interest rates in establishing the kingdom's monetary policy; however, SAMA deals with interest in its international market operations because it carries foreign bonds and securities in the portfolio and as reserves. But using the interest rate as the major indicator in domestic monetary policy is not considered to be the same as taking interest on bonds and other securities purchased outside the kingdom. For the interest rate to become the major indicator requires its recognized existence in the economy, which is not the case in Saudi Arabia.

Primary Tools

In most economies there are primary and secondary monetary tools available to the monetary authorities for the implementation of monetary policy. This section provides a discussion of the available tools, presented as an analysis and comparison of Saudi and Western monetary systems.

Central banks need tools to regulate the money supply in carrying out monetary policy, and the primary tools of monetary policy are open-market operations, the discount rate, and the minimum required reserve ratios.[11] The first tool, open-market operations, as discussed in the previous section, is not available to SAMA. The kingdom no longer has any public debt and hence no government bonds which can be purchased and sold through the banking system in order to expand or contract the money supply through open-market

operations. Also, the money market in the kingdom is not yet developed to the degree where it could handle such operations even if the option were available.

Open-market operations are very effective in changing the money supply in the economy. For example, if the Federal Reserve System in the United States wants to increase the money supply, it buys the securities through dealers from the banks or from members of the general public. The Federal Reserve actually gives the seller a check, which is a claim on money, and holds the bond or security, which is not money, effectively increasing the lending power and the money supply. On the other hand, if the Federal Reserve wishes to decrease the money supply, it will sell bonds and securities in the open markets. This transaction will result in placing bonds with individuals, who pay for them by check, with the result that there will be a decrease in the money supply. In short, selling and buying government bonds and other securities gives the monetary authority the power to aim the money supply at the desired level to promote economic stability.[12]

Discount rates represent for the central bank a second primary tool. The discount rate tool normally is used in conjunction with a large open-market transaction, with the central bank serving the commercial banks almost in the same way that the banks serve their customers. The commercial banks can borrow from the central bank, which charges a discount rate on the loan. When the commercial banks borrow from the central bank, their reserves will be increased, which permits them to increase their lending ability. The end result of this is an increase in the money supply in the economy.[13] SAMA, however, has never extended loans in any form to the commercial banks. While the primary reason for SAMA's inability to develop a discount capability may be tied to the interest rate problem, the system also is not yet ready for this development, primarily due to the dearth of sufficiently trained bankers in the financial system.

The legal reserve ratio is the third major tool used to regulate the money supply. Commercial banks usually are required to hold a certain minimum percentage of their deposits in reserve, either in a reserve account with the central bank or as cash in their own vaults. By changing this ratio the central bank normally can effect an increase or decrease in bank loans, which will result in adjustments in the amount of money in the economy. The central bank thus is able to set the required reserve ratio so that it leads towards the desired money supply. The required reserve ratio is a very effective tool, and central banks seldom use it, mainly because even a very small change in the ratio has a significant effect on the banking community and results in large and abrupt changes in the money supply.

SAMA has the required reserve tool available and uses it in effecting monetary policy, as discussed in the previous section on SAMA development and banking control responsibilities. In fact, the required reserve ratio is the only primary tool available to SAMA, but it is made effective by various secondary monetary tools discussed below. The power of the required reserve ratios may serve to offset the disadvantage that SAMA faces due to the lack of

open-market operations and the discount rate tool. While SAMA did not begin to use the reserve requirement tool until January 1959, 7 years after its establishment, it has used it whenever needed to carry out monetary policy.[14] For instance, in the attempt to encourage the commercial banks to extend more longer-term loans, it reduced the reserve ratio for demand deposits from 15 percent to 12 percent in late 1979 and then to 7 percent in February 1980, along with a similar decrease in the required time deposit reserve ratio, effecting an increase in bank funds available for loans to the private sector for economic diversification.

Secondary Tools

The primary monetary policy tools are the most effective, but since SAMA has only one of these tools at its disposal, the required reserve ratio, it is forced to utilize secondary monetary policy tools. The first of these is moral suasion, i.e. the attempt of the central bank to influence commercial bank lending and other activities, in general by persuasive rather than other means.[15] This tool, however, has not been especially effective, because when faced with a crucial decision the commercial banks may have to choose between central bank advice and profit maximization. Thus, while SAMA uses persuasion and advice in carrying out monetary policy, and its power of retribution clearly is recognized, it would be very difficult for bank management to ignore the policy position of its board of directors, especially with significant out-of-kingdom forces brought to the front in a crisis.

A more significant secondary tool available to SAMA is selective credit controls. For example, the US Federal Reserve System has regulated the margin requirement on stocks and also has regulated the length of the repayment period on instalment loans. If the stock margin requirement is 50 percent, an individual investor is required to defray only 50 percent of the purchase price for the security from his own money and can borrow the remainder, using the stock as collateral for the loan. While providing leverage for the investor and effectively adding liquidity to the financial system, the margin requirement can work both ways, squeezing the borrower during a drop in stock values.

Since there is as yet no meaningful secondary securities market in Saudi Arabia, margin requirements have no significance. SAMA, however, does have various credit controls it can manipulate to regulate monetary activity. These controls include:

(1) maximum limits on total loans that can be extended;
(2) limitations or prohibitions on specific categories of loans;
(3) terms and conditions of transactions for their customers;
(4) cash margins required against specific categories of credits or guarantees;
(5) fixing the assets to be held within the kingdom by each bank.[16]

Article 8 of the Banking Control Law prevents the banks from lending more than 25 percent of their reserves and paid-up capital to one entity (person or

organization). However, at the agency's discretion this percentage can be increased to up to 50 percent, giving the central bank substantial leverage over the commercial banks.[11] These secondary tools provide SAMA with the ability to control credit by making it more or less attractive to the bank and customer. This, in turn, effectively increases or decreases the money supply, which is the basis of monetary policy.

SAMA can also sell dollars to the commercial banks, an operation which decreases the money supply. On the other hand, SAMA does not buy dollars or any other foreign currency from the commercial banks. If SAMA did purchase foreign currencies it would also be able to inject money back into the market, providing it with a more flexible monetary policy tool. Whether SAMA should use dollar purchases and sales as another means to increase or decrease the money supply depends on a number of considerations, especially its ability to implement and maintain such a program.

SAMA also uses its own accounts and government deposits with the banks to alter the money supply. These accounts may be used for various government expenditures, directly affecting the money supply or creating money in the banks. Whether or not the SAMA accounts and government deposits are placed purposely to affect liquidity may be questioned, but there is no question that these placements significantly affect the kingdom's macroeconomic performance both through the banking deposit activity and the spending generated through various government agencies.

Monetary Policy Objectives

Monetary policies in the more developed countries are generally aimed towards the maintenance of the value of the nation's currency and general monetary stability. While these can be considered short-run objectives, they may become long-run monetary policy objectives as well. In Saudi Arabia and other developing countries, however, monetary policies are aimed not only at the maintenance of monetary stability but also towards encouraging the growth of an adequate money and banking system. Monetary policies are also used to support and promote economic growth, a long-run objective. Saudi Arabia, with its ambitious development plans, needs an adequate and stable money supply and banking system. Consequently, the kingdom's monetary policy is designed to achieve the short-run objective of maintaining internal and external monetary stability and banking growth, but these are only preconditions to the long-run objective of economic diversification.

Saudi Arabia's development into a world-class financial power is due in part to the quadrupling of oil prices in 1973 and the resultant stability and underlying strength of the Saudi riyal (SR). With 100 percent gold and foreign reserve backing, the riyal is perhaps the only major currency of such strength. The riyal is managed by SAMA, which administers controls over the currency activities of all financial institutions in the kingdom. There were no monetary or currency regulations prior to 1952, when SAMA was formed. In addition,

there were no Saudi commercial banks, and the money exchangers were the only Saudi financial institution conducting banking-type activities in the country. In the absence of a central bank, the Ministry of Finance and National Economy was responsible for the issuance of currency and coins. In the pre-1952 period the full-bodied silver riyal was the standard monetary unit, but it was not a convenient medium of exchange for transaction purposes. There were periods when the value of the riyal fluctuated violently, due primarily to the bulges of seasonal currency demand in the domestic economy because of the pilgrimage, and also to fluctuations in the international price of silver.[18]

Subsequently, the value of the Saudi riyal remained pegged at the rate of 4.50 to the US dollar, corresponding to 0.197 grammes of gold per riyal, until the devaluation of the dollar in 1971. The riyal was adjusted in 1971 to SR 4.15 per dollar, until the final collapse of the Bretton Woods agreements in 1973, which led to the establishment of a new parity at SR 3.53 per dollar. However, the increasing instability of the dollar under floating rates after 1973 resulted in the Saudi government pegging the riyal to the SDR (Special Drawing Right) on 15 March 1975. The SDR is a unit of account, consisting of a weighted average of five currencies. The official parity originally was 4.28255 riyals per SDR, but in order to isolate the riyal from daily fluctuations in the exchange rates, the government maintained a trading band of plus or minus 7.5 percent around parity.

In practice, riyal value has been expressed in terms of the dollar, despite the decline in the world value of the dollar during 1976 and 1977. Because of the relatively large weight assigned to the dollar in the SDR, approximately 33 percent, it was not until the autumn of 1977 that the dollar began to appreciate, and the riyal started to increase slightly in value with respect to the dollar. The riyal reached a level of 3.25 per dollar at the end of October 1978. During the same period the United States began to stabilize the dollar, and it was clear then that the Saudi government had no intention of keeping the riyal overvalued with respect to the dollar since approximately 50 percent of the Saudi foreign assets are denominated in dollars. As the dollar regained upward momentum, the Saudis began readjusting the riyal down, and at the end of May 1983 it stood at approximately 3.43 per dollar, which more or less corresponded to the stated parity of 4.28255 riyals per SDR.

Short-run Objectives

In Saudi Arabia there are two major areas where short-run monetary objectives are critical: (1) money supply and the value of the riyal, and (2) riyal internationalization.

Money supply and the value of the riyal The currency of any nation is the most indispensable element of its financial system and the functioning of its economic system since it is the medium for ultimate settlement of obligations. Consequently, the demand for and supply of money in the economy has been

perhaps the most comprehensively studied of all economic relationships in recent years. Improving the understanding of the demand for and supply of money is thus particularly vital in the development of the financial system.

The first objective of the kingdom's monetary policy is to regulate the money supply and to maintain the external value of the riyal. Because this objective has special importance, the riyal is not allowed to float in the international markets. Saudi Arabia sells its main source of revenue, oil, in dollars, and as a consequence the riyal is closely associated with the dollar. A monetary objective thus has been to reduce this association of the riyal with the dollar because of its undesired implications. To accomplish this objective SAMA periodically devalues or revalues the riyal against the dollar and attempts to maintain a specific exchange rate. SAMA has sought to weaken the relationship between the variations in the value of the dollar and the variations in the value of the riyal. As a consequence, the agency hopes to prevent any decline in the value of the dollar against any other currency from being coupled with a decline of the riyal against that particular currency. Instead, SAMA has connected the riyal to the SDR. The net result is that SAMA has been able to keep the riyal more or less isolated from speculative and other changes in the international money markets.

In Saudi Arabia the substantial increase in oil revenues and the expansion of government expenditures have had a considerable effect upon the money supply and the value of the riyal. The money and banking sector of the economy has also grown, almost in direct proportion to the enlargement of government expenditures. Currency in circulation, demand deposits, time deposits, and bank clearings all have registered substantial increases. They are expected to continue as the government utilizes its oil income for economic development and social welfare purposes.

The monetary base, or the net monetary liabilities of the Saudi government held by the public, is reported in the SAMA annual reports. The reported balance sheet assets of the agency are foreign exchange, gold, foreign bonds, and coins held by SAMA, which are classified as commercial bank deposits with SAMA. The liabilities are composed of notes held by commercial banks and currency held by the public. SAMA's foreign exchange holdings are the dominant element in its foreign asset holdings; the larger the SAMA foreign exchange holdings, the greater the ability of SAMA to create more liabilities against these holdings. Therefore, any increase in foreign exchange holdings will contribute to the growth of the monetary base.

SAMA gold is the second principal component of the monetary base. The advantage of holding gold rather than foreign exchange is that the value of gold, in terms of other foreign currencies, is not affected by the behavior of any particular currency. However, if a country's obligations are largely in terms of a specific currency, then it is advantageous to hold some of that currency rather than gold because of the variance in the value of the gold in that currency. Like foreign exchange, the larger the SAMA gold holdings, the more liabilities SAMA can create against those holdings.

Foreign bonds, the third foreign asset component, are equivalent to gold and foreign exchange asset holdings as a means of expanding the monetary base. Whenever more reserves are needed, SAMA can sell foreign bonds for gold or foreign exchange assets. Therefore, the effect of foreign bonds on the monetary base is similar to that of gold and foreign exchange.

The process of additions to and subtractions from the currency supply in Saudi Arabia can be best described by analysing the two main channels for currency flow from SAMA based on directives from the Ministry of Finance and National Economy. In the first channel, SAMA issues notes, at the request of the Ministry of Finance, transferring foreign assets in the same amount from the SAMA Banking Department to the Issue Department in order to back the note issue. At the Banking Department, foreign assets decrease and notes increase by the same amount. The newly created currency is then credited to the government account with SAMA. If the Ministry of Finance and National Economy draws a check for the amount of the currency increase against its account with SAMA's Banking Department, then the currency in circulation will decrease by that amount as a result of the government expenditure.

The second source of currency creation for SAMA is through open-market operations in foreign exchange. These operations occur when SAMA buys foreign exchange from the commercial banks which offer foreign exchange for local currency. SAMA may also go to the foreign exchange market, commercial banks, or money exchangers engaging in foreign exchange operations. When SAMA buys foreign exchange from these sources, foreign assets in the SAMA Banking Department will increase, and notes in the Banking Department will decrease by the same amount. Thus, SAMA can increase or decrease bank reserves and the currency supply by buying or selling foreign exchange in the foreign exchange market.

The Saudi government needs riyals to cover the expenditures of various ministries, departments, and independent agencies for goods and services. Consequently, the newly created currency enters the non-bank private sector in the form of cash payments for goods, services, wages, and salaries. One example is the specialized credit or funding agencies of the Saudi government, such as the Public Investment Fund, the Real Estate Development Fund, and the Saudi Industrial Development Fund, which provide loans to the private sector. For example, when one of the specialized credit agencies accepts a loan request from a Saudi industry or an individual, it writes a check against its account with SAMA, and the currency in circulation increases by that amount. Currency also flows into the non-bank private sector through foreign companies and foreign contractors. These firms need riyals to cover their expenditures for goods and services as well as wages and salaries. To cover their expenditures, the foreign companies sell some of their foreign assets in the form of foreign currency to SAMA, and then SAMA issues new notes equal to the amount of foreign currency it gets from the foreign companies.

The last currency expansion factor relates to SAMA's regulation of the liquidity position of the commercial banks. This is made possible by transfer-

ring government deposits from SAMA's Banking Department to the commercial banks designated to receive them, enabling these banks to respond to an increasing demand for credit as well as to cover the wages and salaries of government employees.

Growth in the monetary base The increase in the money supply is dominated by government expenditures, which have increased substantially in the past few years. As a result of the increases in demand deposits and time savings, along with government expenditures and currency in circulation, total commercial bank deposits have grown from SR 3.8 billion in 1973 to SR 89.3 billion in 1982.[19] Yet there are two related monetary factors which effectively confuse the currency in circulation and other liquidity data. The first factor is the increase in foreign travel by Saudi citizens and the arrival of many foreigners in Saudi Arabia for the hajj season, bringing foreign currencies. However, the most important factor confusing the monetary growth data is the unique role of the Bahraini Offshore Banking Units (OBUs) which have adversely affected the accuracy of the measurements of currency growth in the kingdom. Saudi riyal deposits with OBUs come not only from Saudi banks and investors but also from international companies engaged in contracts in Saudi Arabia which either receive or expect to receive riyals payments. This means that even though SAMA has announced many times that it would not be favorably disposed towards the internationalization of the riyal, it has been difficult for SAMA to deal with the problem because it no longer completely controls the money supply. To make this point, it is worth noting that at the end of September 1979 Saudi riyal transactions accounted for approximately $6 billion of the total of $27 billion in OBU assets.[20]

To demonstrate the monetary development process, Table 2.1 shows currency in circulation data from 1973 through 1982, which increased from SR 2.9 billion to SR 30.4 billion. The trends shown indicate that year-to-year growth,

Table 2.1 SAMA: monetary activity, 1973–1982 (billions SR)

	1973	*1974*	*1975*	*1976*	*1977*	*1978*	*1979*	*1980*	*1981*	*1982*
Currency in circulation	2.9	4.1	6.7	10.6	15.6	18.8	22.8	25.5	28.7	30.4
Demand deposits	2.3	3.7	7.4	13.6	20.8	27.8	30.2	33.3	39.2	46.2
Money supply (M1)	5.2	7.8	14.1	24.2	36.4	46.6	53.0	58.8	67.9	76.6
Time and savings deposits	0.8	1.1	1.6	1.9	2.4	4.1	5.8	10.0	18.7	26.7
Money supply (M2)	6.0	8.9	15.7	26.1	38.8	50.7	58.8	68.8	86.6	103.3
Quasi-money	1.8	2.6	3.9	5.7	7.9	9.6	13.2	19.0	31.6	43.2
Money supply (M3)	7.8	11.5	19.6	31.8	46.7	60.3	72.0	87.8	118.2	146.5

Sources: Compiled from *SAMA Annual Report, 1398* (1978), pp. 128–131; *SAMA Annual Report, 1401* (1981) pp. 129–130; and *SAMA Statistical Summary 1402* (1982) pp. 14–17.

however, was not steady, and that the most significant development occurred in the early years of the period. The growth of money in circulation was in response to the kingdom's five-year development plans. For the first development plan (1970–1975) the Ministry of Planning called for the organization of the General Investment Fund (now the Public Investment Fund). The objective of this agency was to finance investment in production-oriented diversification projects. This, along with the benefits of increased oil revenues, spurred an increase in government spending and the money supply.

Table 2.2 indicates that the most significant percentage growth of money in circulation during the period occurred between 1973 and 1976. Currency in circulation growth has slowed considerably since 1976, coincident with the Saudization (the transfers of banking system ownership to Saudi majority ownership and control) of the commercial banking system. Between 1973 and 1977 it grew at a 52 percent average annual compound growth rate, but between 1978 and 1982 it slowed to a 13 percent growth rate. During 1982 the year-to-year growth fell to 6 percent, the lowest rate of growth in the monetary activity analysis.

Table 2.2 SAMA: monetary growth, 1973–1982 (percentage)

	1973	*1974*	*1975*	*1976*	*1977*	*1978*	*1979*	*1980*	*1981*	*1982*
Currency in circulation	41	63	58	47	21	21	12	13	6	
Demand deposits	61	100	84	53	34	9	10	18	18	
Money supply (M1)	50	81	72	50	28	14	11	15	13	
Time and savings deposits	38	45	19	26	71	41	72	87	43	
Money supply (M2)	48	76	66	49	31	16	17	26	19	
Quasi-money	44	50	46	39	22	38	44	66	37	
Money supply (M3)	47	70	62	47	29	20	22	35	24	

Average annual compound growth (percentage)

	1973–1977	*1978–1982*
Currency in circulation	52	13
Demand deposits	73	14
Money supply (M1)	63	13
Time and savings deposits	32	60
Money supply (M2)	59	19
Quasi-money	45	46
Money supply (M3)	56	25

Sources: Compiled from *SAMA Annual Report, 1398* (1978), pp. 128–131; *SAMA Annual Report, 1401* (1981) pp. 129–130; and *SAMA Statistical Summary 1402* (1982) pp. 14–17.

Demand deposits have also increased substantially. While demand deposits rose from SR 2.3 billion in 1973 to SR 46.2 billion in 1982, the most significant rates occurred in 1975 and 1976. This growth was due largely to the first five-year plan, which established a new classification system for government employees, raising salaries and as a result effecting a substantial increase in demand deposits. Accordingly, the compound growth rate declined from 73 percent between 1973 and 1977 to 14 percent between 1978 and 1982. The major decline in 1979 and 1980 was caused largely by a slower growth rate of government domestic expenditures and an enlarged private sector balance of payments deficit. This had an offsetting effect on the previous rapid rise in bank credit to the private sector. The decline in growth of demand deposits also was due to a growth in the transfer of deposits abroad, in response to the higher interest rates available outside the kingdom.

In addition to the growth of money in circulation and demand deposits, there was an increase in time and savings deposits in the kingdom, from SR 0.8 billion in 1973 to SR 26.7 billion in 1982. Even more significant is the compound annual growth rate which registered 32 percent for 1973–1977 and 60 percent for 1978–1982. Time deposits vary considerably with international interest rates, but several other factors also were responsible for the sharp rise during the analysis period. The first factor was the growth in incomes, the second was the relatively low utilization rate of current account services to match the growth in incomes, and the third was the lack of effective channels for foreign investment.

There is considerable evidence that the direct relationship between income and demand and time deposit growth observed in the United States and other Western nations applies to Saudi Arabia as well. Table 2.2 shows that for the last 5 years of the analysis there was more growth in savings deposits than in demand deposits. It is considered almost universally true that except for a rather limited range of financial activity, checking (current) accounts normally are not used in lesser developed countries to make transactions. Thus, the choice facing individuals in the lesser developed countries is not between currency and demand deposits, but rather between currency and savings or time deposits. The growth of time and savings deposits relative to demand deposits may reflect the lack of convenience in making payments by check in Saudi Arabia. Further, as noted above, the inefficiency of checking or current account services has been cited as one of the general characteristics of the monetary system in Saudi Arabia because basically it is still a cash economy.

As noted earlier, demand deposits, like currency in circulation, perform a critical role in monetary control activity. A key factor in the steady rise in demand deposits has been the fact that deposit levels will increase as depositors feel confident of the monetary stability in the country and of the soundness of the banking system. This has occurred in several waves in the kingdom. Related to this is the increase in the percentage of the population utilizing checking accounts for payments. Unfortunately, this theorem cannot yet be applied in Saudi Arabia since checking (current account) facilities are not

uniformly available in all areas of the kingdom. A change in this situation is, however, imminent with the increase in branch banking and the modernization of check-clearing facilities. Not only are several of the Saudi and Saudized banks beginning to utilize computers to speed check-cashing facilities, but SAMA is moving rapidly towards the adoption of an advanced check-clearing system.

Another factor tending to increase demand deposits is the credit card system. Many individuals are beginning to utilize American Express and Visa cards, and even though relatively few stores accept credit cards the number is growing. It can be assumed that once there is an increase in confidence in the use of such instruments, as is likely to happen since many more Saudis are travelling overseas and using credit cards and checks, an expansion in demand deposits will occur.

A final consideration in the growth of demand deposits is that the capital accounts of the commercial banks in Saudi Arabia, as elsewhere, are viewed as a cushion to protect the depositor against bank insolvency. Further, since there is no statute of limitations in the kingdom, every depositor knows that he eventually will receive his deposit, even if the bank goes into insolvency. The Saudi commercial banks have even more substantial capital positions than banks in other regions of the world due to the SAMA reserve restrictions and past profitability which has enabled them to increase reserves in their equity accounts. This naturally encourages depositors to place their current and time deposits, as well as their investment funds, with the local banks. These factors, combined with the growing awareness of the cost of holding non-interest bearing funds, computerization of the banking system and constant improvements in the quality of bank management, are encouraging individuals and firms to use bank facilities and services. The conclusion is that in the long run the currency in circulation and demand deposit ratio will decline proportionately with the increasing use of checking accounts and other deposit accounts.

A major factor in the heightened ability of the banking system to respond to various money market opportunities is the fact that monetary activity in Saudi Arabia slowed down after 1978, due largely to the increased ability of SAMA and the banking system to handle new pressures and absorb the funds accruing from higher oil prices. In addition, a slower growth in government domestic expenditures, and an increase in the private sector balance of payments deficit, was critical. Dropping from a high money expansion rate of 70 percent in 1975, the total money supply (M3) grew only 20 percent in 1979, and 24 percent in 1982, as noted in Table 2.2. The velocity of the money supply in the economy also began to decline after 1977, with only a mild resurgence in 1981, bringing down with it demand and the associated inflationary pressures.

The compound annual growth rate is also useful in understanding the monetary growth process. M1, M2, and M3 all grew at a slower rate during 1978–1982, but the steepest drop clearly was in the currency in circulation and demand deposits, as monetization and the banking habit began to set in with businessmen and consumers. Significantly, the only money supply component other than time deposits to grow during 1978–1982 was quasi-money. This

important money category, made up primarily of bank deposits held in support of trade and construction finance credit, has continued to grow and may be the last but most important monetary sector to experience the impact of the 1982 downturn in oil volumes and prices.

To place monetary growth in perspective, Table 2.3 shows that as a percentage of total monetary activity, currency deposits are now in second place, after quasi-monetary deposits, and time deposits are in a position to move into a development-oriented first place in the coming years. As the infrastructure of the kingdom is completed during the Third 5-Year Development Plan, and as the expected secondary industry in the kingdom develops, the quasi-money category should decline in importance.

Table 2.3 SAMA: monetary activity, 1973–1982 (percentage of total)

	1973	*1974*	*1975*	*1976*	*1977*	*1978*	*1979*	*1980*	*1981*	*1982*
Currency in circulation	38	36	34	33	33	31	32	29	24	21
Demand deposits	29	32	38	43	45	46	42	38	33	32
Money supply (M1)	67	68	72	76	78	77	74	67	57	53
Time and savings deposits	10	9	8	6	5	7	8	11	16	18
Money supply (M2)	77	77	80	82	83	84	82	78	73	71
Quasi-money	23	23	20	18	17	16	18	22	27	29
Money supply (M3)	100	100	100	100	100	100	100	100	100	100

Sources: Compiled from *SAMA Annual Report, 1398* (1978), pp. 128–131; *SAMA Annual Report, 1401* (1981) pp. 129–130; and *SAMA Statistical Summary 1402* (1982) pp. 14–17.

Money availability is at least partially a result of credit availability, as noted in the individual commercial bank balance sheets and income statements, creating a gradually improving credit situation for the private sector. A closer look at the money expansion rate shows that sharp increases occurred between 1974 and 1980 for three interrelated reasons:

(1) Specialized credit agency disbursements, which rose from SR 15.7 billion in 1976–1977 to 19.6 billion in 1977–1978, declined to SR 17.3 billion in 1978–1979 before rising to approximately SR 19 billion in 1979–1980.
(2) The balance of payments current account moved from a balance of SR +50.3 billion in 1976 to SR −7.5 billion in 1978.
(3) Bank documentary credit rose from SR 22 billion in 1976–1977 to over SR 35 billion in 1979–1980.[21]

These factors, which indicate the gradual monetization and development of the financial system, played a key role in relieving strains on liquidity and enabled achievement of the second development plan goals without substantial inflation.

One of the major SAMA goals during the second development plan period (1975–1980) was to control the flow of loanable funds. This occurred while the banking system was beginning to develop some of the sophisticated tools necessary to deal with international financial pressures coming from outside the kingdom as a result of foreign bank activity in Saudi Arabia. Thus, the shift towards slowing the amount and pace of monetary activity has been premeditated. As shown in Table 2.2, the total money supply moved from an expansionary annual compound growth rate of 56 percent between 1973 and 1977 to a more moderate and development-oriented 25 percent growth rate between 1978 and 1982. During this period, however, SAMA took an otherwise passive role in allowing outbound flows of funds for imports and investments and enabling the free market to tighten the screws on loanable funds automatically rather than doing it artificially. In this manner SAMA policy is almost inadvertently forcing the banking system to prepare itself for the day when the degree of monetization now occurring will encourage an efficient creation of loanable funds without artificial controls and policies.

Commercial bank credit expansion provides another possibility for the future direction of internal money market growth in Saudi Arabia. The first indication is the fact that commercial bank loans (domestic loans, advances and discounts, and domestic investments) are up over the last few years. (See Table 2.4.) Increasing 33 percent in 1977–1978, this category 'took off' in 1978–1979 to achieve a 75.9 percent increase. By late 1979 private sector bank credit demand was up an additional 31 percent. In this category loans, advances, and discounts are the most significant, increasing from SR 8.4 billion in 1977–1978 to SR 19.7 billion in 1978–1979, comprising over 96 percent of total private sector claims.

Table 2.4 Loans to deposits analysis, 1973–1982 hijra fiscal years (billions SR)

	1973	*1974*	*1975*	*1976*	*1977*	*1978*	*1979*	*1980*	*1981*	*1982*
Loans	1.8	3.2	5.4	8.5	8.4	11.2	19.7	29.2	40.3	46.6
Deposits										
Demand deposits	2.3	3.2	5.6	11.0	17.6	27.3	29.5	30.5	37.3	46.2
Quasi-money										
Time dep.	0.8	0.9	1.5	1.6	1.8	3.1	4.2	9.5	13.1	26.6
Other	0.7	1.3	1.9	3.3	4.3	5.3	6.7	7.5	11.0	16.5
Subtotal	3.8	5.4	9.0	15.9	23.7	35.7	40.4	47.5	61.4	89.3
Loans–deposits ratio (%)	47	59	60	53	35	31	49	61	66	52

Sources: Compiled from *SAMA Annual Report, 1398* (1978), pp. 128–131; *SAMA Annual Report, 1401* (1981) pp. 129–130; and *SAMA Statistical Summary 1402* (1982) pp. 14–17.

While there was some moderation in the growth rates for loans, advances, and investments during 1979–1980, private sector bank credit demand still continued to increase, indicating that the slowdown enabled the economy to digest the earlier ultra-high expansion rates. An additional moderating factor was the reduction in funding agency disbursements which occurred when the government attempted indirectly to force the commercial banking system to provide more of the normal capital and other loan financing for local industrial and housing development. A major factor in this process is the successful organization of local industrial development efforts. The number of operating industrial establishments increased from 583 in 1976 to over 900 in 1980, and over 50 percent of the 1980 group was manufacturing concerns compared to less than 20 percent in 1976.[22] This situation has aroused greater interest on the part of banks in regular commercial financing operations, inventory financing, bridge financing, and various types of medium-term lending activities. These bank loan operations could be the basis for yet another area of financial market development which could include bankers' acceptances and commercial paper. All that is needed for the beginning of a secondary market is acceptance of the principle and encouragement from the monetary authorities.

Table 2.4 also indicates the level of banking response to the development of manufacturing enterprises. The ratio of financial support for construction is levelling off but has not yet begun the expected decline as infrastructure project activity nears completion. Also, the growth of manufacturing credit support has not advanced to its full potential due to consolidation of the earlier advance and the absorptive limits of the Saudi markets. SAMA loan limit restrictions on the commercial banks have also caused much of the construction finance activity to move out of the kingdom, to Bahrain, potentially shifting more local commercial bank loan activity to industrial finance. This healthy shift could gradually eliminate much of the short-term nature of the kingdom's financing activity. Another potential for future financial intermediation is found in the fact that, despite the movement from construction to manufacturing financing, stringent SAMA reserve requirements and levels are changing very slowly. The movement should be considered healthy since it will improve the equity positions of the commercial banks and the underlying potential for future banking expansion, making the shift from short- to medium- and long-term financing easier and stronger. Thus, while the predominance of short-term finance for commerce and construction naturally will continue for some time, the rate of growth is slowing, to the benefit of other economic sectors.

The deposit structure in the monetary system thus has developed a great deal of potential for creation of loanable funds, as evidenced in the trend taking place in demand and time credits. Combined with the growth in quasi-money activity, this trend provides an indication of the potential for future development of financial intermediaries and broader bank money market service activities, utilizing investment-type instruments such as bonds, stocks, debentures, and commercial paper.

Riyal internationalization The second major short-run objective related to monetary development and the stability of the riyal is the problem of riyal internationalization. The increasing importance of Saudi Arabia in international trade led to the riyal being designated in 1978 as one of the five currencies in the basket used to define the Special Drawing Right. The weight of the riyal in the SDR was 3 percent, proportional to the share of Saudi exports in the total exports of the five countries involved in the SDR formula.

The riyal has the backing to become an international currency, but SAMA has strongly opposed such a move because of the implications for internal financial development. The total money supply of Saudi Arabia is approximately SR 100 billion, with roughly one tenth of it offshore in Bahrain and several other international money market centers. While SAMA does not control the offshore market as tightly as the domestic sector, it has had sufficient influence to prevent several attempted floats of Saudi riyal-denominated Euroloans.[23]

One measure that SAMA has taken to maintain proper control of the riyal market is participation in various Saudi international banking operations, such as the London-based Saudi International Bank which is 50 percent owned by SAMA, for better control of offshore riyal markets. This activity has been required because of the limited number of markets for riyals. The only international riyal markets, other than Bahrain, are in London and Paris. It would be possible for banks to get riyals in Saudi Arabia, but the interbank market is thin and there is almost no wholesale banking sector. The primary international riyal money market is in Bahrain where SAMA has tolerated riyal money market activity. The Bahrain OBU market has not diminished since SAMA has steadfastly refused to open the Saudi market to foreign banks, which consequently draws riyals offshore. SAMA's concern over possible riyal internationalization is understandable in the light of the volatility of the international currencies over the last 10 years. Despite the fact that the riyal is not allowed to float in the international markets, the riyal could end up eventually in a position similar to that of the Swiss franc, the sought-after bedrock currency of a small country with abundant monetary reserves.

Since the riyal is not a widely used international currency, the discussion of dollar-linked riyal devaluations would appear to be academic. Most foreign firms working in the kingdom operate on government contracts which exempt them from normal currency payment restrictions. Until 1980 these firms received their contract payments mainly in riyals. Consequently, the firms related the riyal to other currencies. The willingness of these firms to bid on work in the kingdom was, to some degree, affected by the relationship established between the currency they were paid in and their home currency. Since the effect was not always positive, SAMA determined in 1980 that logically it was better to eliminate the problem of substantial outflows of riyals by tighter controls on riyal movements.

SAMA's initial concern about riyal internationalization came as a result of bank riyal dealing in Bahrain and the incorporation of the riyal as a strong oil-backed unit in the basket of currencies used by a number of governments. Clearly, the Saudi economy, like the Swiss economy, is not large enough to support a reserve role for its currency. To solve this problem SAMA first had to deal with the liquidity problem caused by the large number of riyals being pulled out of the kingdom to Bahrain in response to higher interest rates and the considerable speculation in the riyal. In response, SAMA decreased the required reserve ratio from 15 percent to 12 percent in May 1979, and then to 7 percent in February 1980. This solved the liquidity problem in the local market by freeing new bank resources. SAMA also sought to become unpredictable in order to halt riyal speculation. Consequently, in March 1980, SAMA revalued the riyal upward against the dollar despite all expectations and market pressures for devaluation.[24]

The second step SAMA took to halt internationalization of the riyal was a change in the payments for government contracts. All contract obligations with foreign firms exceeding SR 300 million ($90.3 million) in value are paid in dollars. This decision, made in October 1980, resulted in construction firms obtaining riyals in the Bahraini OBU market, an action which has pulled riyals back to the kingdom.[25] This action has meant that firms and banks may speculate in dollars against their home currencies as they deal in foreign exchange, but they will not be able to speculate in the riyal. The question of whether or not SAMA should internationalize the riyal has not yet been finally answered, but it seems that it has been successful thus far in preventing riyal internationalization and has accomplished its basic short-run monetary objectives.

Long-run Objectives

In order for the economy to handle effectively the kingdom's five-year development plans there must be an adequate money and banking system. If this system is not effective the accomplishment of the development plan objectives will be much more difficult, with a consequent cost in money and time. Recognition of this factor led SAMA, during the 1970s, to acknowledge that the kingdom was underbanked for its development needs. It was apparent that the system was too dependent on the two Saudi banks (Riyad Bank and National Commercial Bank), and that the foreign banks were concentrated in the main cities. Since the foreign banks were not allowed to open branches they could not effectively aid the monetization process. In general, the banking system at that time was not large enough to handle properly the financial requirements of the development plans. The banks were very conservative in their lending policies, and banking activities were not systematically operated, depending heavily on the name, status, and reputation of the customer rather than objective financial criteria. In sum, while there are many important factors in deciding whether or not to extend a loan, in the pre-bank Saudization era some of these factors were given much more weight than they should have received, making the need for better banking services obvious.

SAMA also has attempted to encourage a more stable banking system by building longer-term bank deposits. There has been some success with this objective because demand deposits in 1979–1980 decreased to less than 70 percent of the deposit total while time deposits increased to 13.4 percent. However, accomplishment of the long-term goal has been difficult because, in order to increase longer-term deposits, SAMA squeezed the money supply and allowed interest rates in the marketplace, which it cannot control, to rise. While M3 has fluctuated between 1978 and 1981, the increase in interest rates generally has made it attractive for individual depositors to place funds in time deposits rather than demand deposits. The increase in time deposits also has helped to encourage the banks to increase the number of loans and to improve the terms of these loans, further monetizing the economy.

Since the development of the banking system will take a relatively long time, and the economic diversification plans cannot be delayed indefinitely, the specialized credit agencies of the government, which will be discussed in Chapter 5, also have a role in monetary policy. While the development plans provide some indirect and often intangible incentives for banking system development, the specialized credit agencies provide a more direct form of monetary policy input because they carry out some of the functions the banks cannot perform. Thus, while the credit agencies effectively may delay the development of the banking system due to the fact that they take some of the banks' share of the financial market, they provide considerable impetus for and influence over the course of the development plans.

Monetary policy development in Saudi Arabia is a combination of short- and long-run objectives. The short-run objective is to maintain monetary stability, and SAMA has been effective in accomplishing this goal. For example, the 1975 inflation basically was halted by substantial physical additions to the ports, airports, and highways, which were made possible through government funding efforts, backed by SAMA. The long-run objective is development of an adequate monetary and banking system to handle the financial needs of the development plans, for both the public and private sectors. Bank Saudization was a step towards this goal, with wider geographical coverage by bank branches. The specialized credit agencies also are helping in the course of development, but banking growth will effect the required increases in time deposits and monetization in the economy in order to reinforce the banking concept in the kingdom. Unfortunately, most of SAMA's monetary tools are secondary rather than primary, thereby blunting much of the impact of the policy before it effectively takes hold in the economy. The unavailability of the main primary monetary policy tools obviously deprives the kingdom of the stabilizing force which could increase the monetization of the Saudi economy.

DISCUSSION QUESTIONS

2.1 Briefly describe the history of the Saudi Arabian Monetary Agency.
2.2 What are the main responsibilities and functions of SAMA?

2.3 What are the reasons that have led to the need for possible restructuring of SAMA's operational framework?
2.4 Describe SAMA's currency affairs function and its role in stabilizing and maintaining the value of the Saudi riyal.
2.5 Describe SAMA's commercial bank responsibilities.
2.6 What is the major research activity performed by SAMA? Discuss.
2.7 What are the main features of the Saudi Banking Control Law?
2.8 In Saudi Arabia, the interest rate is not and cannot be the major indicator of monetary policy. Why?
2.9 Briefly describe the primary and secondary monetary tools available to monetary authorities to implement monetary policy. Are these tools used by Saudi monetary authorities? Discuss.
2.10 Distinguish between monetary objectives in the more developed countries and the monetary objectives of the developing Saudi Arabia.
2.11 Briefly discuss the two major areas where short-run monetary objectives are critical to Saudi Arabia.
2.12 What are the principal components of the Saudi monetary base?
2.13 Briefly describe the growth in the Saudi monetary base.
2.14 What were the measures that SAMA took to halt internationalization of the riyal? Was SAMA successful in this endeavor?
2.15 Discuss the long-run monetary policy objectives in Saudi Arabia and relate them to the short-run objectives.

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CHAPTER 3

Money Market Institutions: I

Achievement of a cohesive development-oriented financial system normally requires substantial money market activity, with the market institutions possessing a clear and purposeful role. There are four categories of money market institutions in the increasingly complicated Saudi Arabian money market: commercial banks, offshore banking units (OBUs), Saudi international banks, and other money market institutions. While these institutions are monitored by the Saudi Arabian Monetary Agency (SAMA) and the Ministry of Finance and National Economy, SAMA possesses only limited legal and money market controls to effect significant changes in their operations.

The major domestic money market institution is the commercial banking system, functioning in its normal banking role and as the main instrument through which Saudi ownership of the kingdom's financial system is being accomplished. Bank Saudization (the transfer of banking system ownership to Saudi majority ownership and control) has served both to eliminate some of the negative outside influences in the banking and financial systems and to create a new capital base for expansion of the system. Daily operating control over the banking system is provided by SAMA through the authority granted by the Banking Control Law of 1966 (see Appendix B) which established reserve and housekeeping controls over the commercial banks.

This chapter provides an analysis of the evolution of bank Saudization and the changing status, growth, and profitability of the commercial banks in directing much of the kingdom's day-to-day money market activity. Proceeding from a review of the banking environment before Saudization and the Saudization process, there is a consideration of the sources of profit for the Saudi banks. The next section takes up the very important questions of Saudi commercial bank growth, funds utilization, and profitability. Following this is an evaluation of the success of the bank Saudization process, which has served both to increase Saudi control over the money markets and to enhance the credit creation role of the commercial banks. The chapter concludes with an assessment of how the Saudi commercial banking system is responding to the problem of growing competition and declining profits, a subject which may determine its future.

COMMERCIAL BANKS BEFORE SAUDIZATION

The development of commercial banking in Saudi Arabia has been significant in its relatively short history. The first branch of a foreign commercial bank, Netherland Trading Society, today Al-Bank Al-Saudi Al-Hollandi, was established in 1927, concentrating on import and export finance through the port city of Jiddah. Subsequently, other banks opened offices or were established in the kingdom. According to Table 3.1 these banks were classified as 'local banks', 'Arab banks', and 'other banks'.

These commercial banks initially were unpopular because of the social and religious stigma attached to paying and receiving interest. The result was effective promotion of a cash-oriented society in which the combined assets of the commercial banks did not reach SR 4 billion until 1973. Since 1973 banking growth has been nothing short of phenomenal, with total bank assets exceeding SR 110 billion in mid-1982.[1]

After 1973 the increased flow of oil revenues and the infusion of new capital into the commercial banking system from many sources necessitated the expansion of banking services. Despite the rapid growth that occurred between 1973 and 1976, the banking industry in Saudi Arabia failed to provide a level of banking sophistication that matched the advances being achieved by its customers. There was relatively little computerization of bank operations and there was, and still is, no secondary market for money market instruments such as government debt issues and commercial paper; as a result the banking system in Saudi Arabia did not progress as in other areas of the Gulf. Further, several important and complex issues relating to banking policy and regulation

Table 3.1 Commercial banks operating in Saudi Arabia before Saudization

	Head office	*No. of branches*
LOCAL BANKS		
1. National Commercial Bank	Jiddah	34
2. Riyad Bank	Jiddah	34
3. Bank Al-Jazira	Jiddah	3
ARAB BANKS		
4. Arab Bank Limited	Jiddah	6
5. Banque du Liban et d'Outre-Mer	Jiddah	6
6. Banque du Caire	Jiddah	3
OTHER BANKS		
7. Algemene Bank	Jiddah	3
8. British Bank of the Middle East	Jiddah	3
9. Banque de l'Indochine	Jiddah	2
10. First National City Bank	Jiddah	2
11. United Bank Limited	Dammam	1
12. Bank Melli Iran	Jiddah	1
		98

Sources: Adapted from *SAMA Annual Report, 1397* (1977), p. 114.

required resolution before the banking industry in Saudi Arabia would be able to reach its potential.[2]

SAUDIZATION OF THE COMMERCIAL BANKS

The July 1976 decision of the Council of Ministers to effect Saudi ownership, or Saudization, of the kingdom's commercial banks was based on a number of motives. A primary reason stated for Saudization was that the branches of the foreign banks in Saudi Arabia were functioning within policies drawn up by their foreign parent banks. These policies, which were not always in harmony with the kingdom's development plans, resulted in a banking system which financed mainly foreign trade and gave no priority to long-term loans essential to the economic growth of the country. Further, the foreign banks were concentrated in the largest cities of the kingdom, Jiddah, Riyadh, and Dammam, and were not allowed to increase their capital base in order to provide banking services for the underbanked rural towns and villages. Also, as a result of the rapid development of the country, and the fact that the foreign banks were not properly regulated by SAMA, the high profits earned were mostly transferred outside the kingdom.[3]

As a consequence of the bank Saudization program, essentially completed in 1980, the commercial banks may be grouped into 'local banks' and 'other banks'. (See Table 3.2.) The 'local banks' category includes the two 100 percent Saudi-owned banks, National Commercial Bank (NCB) and Riyad Bank. NCB is the largest commercial bank in the Middle East, with 125 branches in the kingdom. Riyad Bank is the second largest bank in Saudi Arabia, with 97 branches in the kingdom.[4]

Table 3.2 Saudized commercial banking system

	Head office	*No. of branches*
LOCAL BANKS		
1. National Commercial Bank	Jiddah	125
2. Riyad Bank	Jiddah	97
3. Bank Al-Jazira	Jiddah	11
4. Al-Bank Al-Saudi Al-Britani	Riyadh	20
5. Al-Bank Al-Saudi Al-Hollandi	Jiddah	10
6. Al-Bank Al-Saudi Al-Fransi	Jiddah	23
7. Arab National Bank	Riyadh	41
8. Saudi Cairo Bank	Jiddah	22
9. Al-Bank Al-Saudi Al-Amiriki	Riyadh	13
OTHER BANKS		
10. Banque du Liban et d'Outre-mer	Jiddah	1
11. United Bank Limited	Dammam	1
12. Bank Melli Iran	Jiddah	1
		365

Sources: Adapted from *SAMA Statistical Summary, 1402* (1982), p. 59.

The Saudized banks included in the first category, 'local banks', are seven formerly foreign banks which were converted to 60 percent Saudi-owned banks (excluding Bank Al-Jazira which opted for 65 percent Saudi ownership). The largest of the Saudized banks in terms of assets is the Al-Bank Al-Saudi Al-Amiriki (Saudi American Bank), an affiliate of New York's Citibank. The Al-Bank Al-Saudi Al-Fransi (Saudi French Bank), an affiliate of France's Banque de l'Indochine et de Suez, is second on the list, followed by the Al-Bank Al-Saudi Al-Hollandi (Saudi Dutch Bank), which operates in conjunction with Algemene Bank Nederland, and the Al-Bank Al-Saudi Al-Britani (Saudi British Bank), an affiliate of the British Bank of the Middle East. The other local banks include the Arab National Bank, partly owned by Jordan's Arab Bank; Bank Al-Jazira, an affiliate of the National Bank of Pakistan; and the Saudi Cairo Bank, partly owned by Egypt's Banque du Caire.

The 'other banks' category includes three banks which did not participate to any significant degree in the banking market and have been absorbed into one Saudized bank. These banks – Bank Melli Iran, Banque du Liban et d'Outre-Mer (Lebanon), and United Bank Limited (Pakistan) – were Saudized during 1982 and were merged into the new United Saudi Bank.[5]

There are several advantages flowing from the Saudization of the foreign-owned banks. First, the Saudized banks have been able to increase their capital base as well as the number of branches in the country. Foreign banks, until Saudization, were prevented from opening new branches in the kingdom or increasing their capital. With Saudization, foreign banks theoretically can operate on an equal and competitive basis with the two 100 percent Saudi banks. Further, as competition between the banks increases, the public will receive a better banking service at a lower cost. Saudization will also result in spreading the country's new wealth among its citizens, stemming past accumulations in foreign banks.

Bank Saudization was expected to have several other advantages, not the least of which was that the kingdom would benefit considerably from the experience that the foreign banks would bring, especially after they were allowed to expand through branching. As a consequence, Saudi nationals would have considerably more opportunities to work in and manage these banks, and they would have the opportunity to own shares in them. Much of this gain would also stem from the wider geographical area to be covered by the new banks. The result could be an increase in the capital and reserves of the banks, enhancing their ability to lend to individuals, partnerships, and corporations. Last but not least, bank services would be expanded by virtue of the fact that the Saudized banks would be closer to the public and thereby able to respond more flexibly with appropriate banking services.[6]

In terms of the broader objectives, the banking policies of the Saudized banks are being tied more closely to Saudi Arabian national economic and financial interests than to those of the bank source country. This closer alignment of the banks to national economic development policies ensures that

monetary policy should be more effective and more responsive to financial conditions. The Saudized banks will also benefit from government deposits which in the past normally were placed only with the 100 percent Saudi-owned banks, Riyad Bank and National Commercial Bank. Receipt of government deposits will be not only much more likely after Saudization, but all the commercial banks will receive the opportunity to obtain shares in the major government-sponsored industrial companies which will become public in the late 1980s.

The process by which the foreign banks became Saudi joint stock companies was based on the calculation of the book value of the foreign bank, which was set at 40 percent of the capital of the new bank. In this way the foreign banks were able to retain a 40 percent ownership, except in the case of Bank Al-Jazira, which retained only a 35 percent ownership. The remaining 60 percent of capital was allocated between the board of Saudi sponsors (24 percent) and the Saudi public (36 percent).

Saudi control of the banking system has been accomplished primarily by increasing the capitalization of the banks, with the resulting additional shares available to the Saudi public. The initial new equity for all the Saudized banks, except the Arab Bank and Saudi American Bank, was put at SR 100 million. The 'Saudization' of the Arab Bank was SR 150 million, and the Saudi American Bank was capitalized at SR 300 million. The shares were issued at a par value of SR 100 each and heavily oversubscribed, causing rationing of subsequent share issues.[7]

All the Saudized banks have increased their capital bases or are in the process of doing so. The Saudi French Bank, for example, increased its capital to SR 200 million and then later to SR 300 million through a one-for-one stock offering to its Saudi shareholders. Subsequently, the Saudi French Bank obtained a SR 40 million capital addition from the original parent bank, Banque de l'Indochine et de Suez. Similarly, the Saudi British Bank made a two-for-one offering to its Saudi shareholders and raised its capital base to SR 300 million. The motivating force behind the capital base increases has been the high return the Saudized banks have realized since their conversion to Saudi control. The new shares originally were offered to existing shareholders at SR 100, but the heavily traded shares of some banks rose rapidly in value, changing hands at about SR 350 between 1977 and 1979, an increase of approximately 250 percent over the original subscription price. By 1983 the situation was even more extreme, with the same shares selling for over SR 1000. Despite the dilution effected by the new share offering, the shares of the Saudi French Bank traded at SR 450 soon after issuance in the informal Saudi stock market.[8]

The scarcity of publicly traded Saudi companies is also a factor in the bank Saudization process. Saudi five-year development plan emphasis has been on private sector development and Saudi individual ownership of business operations. Accordingly, the specialized government funding agencies were established primarily to extend loans to individuals, not to public corporations. This

practice naturally discouraged the development of a capital market, but the issuance of shares in the Saudi Investment Banking Corporation and the Saudized banks provided the first step towards the creation of a public shares market. The high level of public interest in share ownership and trading in the informal stock market thus provides an indication of the potential for a broader financial market. To ensure a fair distribution of bank ownership, the trading regulations effect a preferential rights process, on the basis of prior stock holdings. After the initial issuance of stock subscriptions, preference is given to small investors, and the larger orders receive the smallest percentage allocation. In this manner bank ownership will be further expanded, and the public will be stimulated to more interest in and awareness of the activities of the banks.

COMMERCIAL BANKING GROWTH AND FUNDS UTILIZATION

Growth Factor Analysis

An analysis of the growth of the Saudi banking system should consider and evaluate the absolute and relative levels of banking activity in order to ascertain the degree to which the banks have succeeded as financial and business operations and make a positive contribution to the economic and financial growth and stability of the kingdom. There are numerous formats available for assessing bank performance, but the unique nature of the Saudi banking system requires variations of the normally accepted techniques. Accordingly, the analysis proceeds from a review of Saudi commercial bank revenue sources to a detailed study of other elements of banking growth in Saudi Arabia: general balance sheet growth, along with deposit, equity, and asset growth. The data in these sections are based on a combination of SAMA data and bank annual reports. The final phase of the growth and utilization analysis provides an evaluation of structural aspects of the deposit, asset, and equity bases of the system, focusing primarily on loan and foreign asset growth as a key indicator of Saudi commercial bank development.

Revenues

The Saudi commercial banks draw on a number of sources of revenues as a base for the continuing development of the banking system. Due to the relatively uncomplicated nature of the financial markets in Saudi Arabia, these sources of revenue still are basic and unsophisticated by Western banking standards. Most revenues are confined to normal banking fee services, local and offshore syndicated loan fees, and returns on local and foreign investments. This confinement is due to local religious restrictions on the receipt and payment of interest and on legal restrictions. An example of the legal restrictions is that a bank is not allowed to own property other than that required for its specific

banking functions. Further, the government has ruled that mortgages are illegal and unenforceable. The consequence is that the banks are not able to obtain revenues from real estate speculation or mortgages. Also, the lack of a government securities market and a secondary financial market preclude another possible revenue source.

An overview of the income statements and balance sheets for the nine largest Saudi and Saudized commercial banks shows that while the Saudi banking system has grown and extended its level of operations, in overall sophistication and in specific activity sectors, the growth in some key sectors has been less than anticipated. In all categories there has been continued growth, but the dominance of the 100 percent Saudi-owned banks in particular is diminishing, and the rapid increase in operating expenses and the lack of relative growth in non-oil economic diversification loans leads to a conclusion that long-term optimism must be tempered by a recognition of past trends.

The majority of revenues from Saudi commercial bank services are basically derived from three main types of banking activities: guarantees, letters of credit, and money exchange. Since most construction contracts awarded in the kingdom involve either foreign companies or firms with foreign partners, the Saudi government generally requires three types of guarantees to ensure proper completion of contractual obligations:

(1) Bid bonds, set at 1 to 2 percent of the value of the contract, to avoid frivolous bids;
(2) Advance payments, usually 10 to 20 percent of the value of the contract;
(3) Performance bonds, which range between 5 and 10 percent, to guarantee the quality of the job performed.*

SAMA allows the commercial banks in Saudi Arabia to charge between ¾ of 1 percent and 2 percent of the value of the guarantee, the exact percentage determined by the time frame of the guarantee. An important aspect of the guarantee activity is that the bank does not actually deposit the guarantee funds with the government. Since defaults in guarantees are extremely rare, this business has become a significant low-risk source of bank income.

Letters of credit, the second major source of income for the banks, are used by all foreign companies exporting to the kingdom, and the banks charge between ⅛ and ¼ of 1 percent of the value of the letter of credit. As with contract guarantees, the risks are minimal.

Foreign exchange for export and import financing activities is another major source of revenue for the banks since foreign trade and finance provide the basis of the economy. Petroleum product sales are still the kingdom's only significant export, there is still relatively little domestic production, and virtually all commercial and consumer products are imported. The combined values of exports and imports exceeded SR 524.8 billion ($153.4 billion) in 1981 and has been increasing, especially for imports. Since these transactions are denominated primarily in dollars, there is a need for a large riyal–dollar exchange market. The banks deal through SAMA for the purchase and sale of their

dollars, allowing SAMA effectively to control the exchange rate. The commissions on riyal–dollar transactions are not excessive (¼ of 1 percent on sums not exceeding SR 100 000, $^{1}/_{16}$ of 1 percent on larger amounts), but the volumes are substantial, enabling the bank to use volume to make up for the low margin. The volume of transactions in other currencies is small when compared with the dollar transactions, and the banks charge much larger commissions when dealing in other currencies.

Exchange commissions entail no risk since exchange rates are fixed, and the positions are cleared every day. Further, neither the dollar nor the riyal can be shorted with SAMA, which announces the rates every morning, and despite some variations in rates recent history has shown a slow devaluation against the dollar. There is considerable stability in exchange commission activities despite the fact that the operation functions effectively only four days of the week due to the difference between the Christian and the Muslim weeks. Even though the inflow and outflow of riyals is tightly controlled by SAMA, more than 10 percent of the kingdom's money supply may be located offshore at any point in time. Consequently, the banks are reluctant to use additional riyals offshore in opposition to SAMA directives.

In addition to income from guarantee and exchange activities, the commercial banks also receive interest from traditional bank loan functions. While lending activities are limited by the Islamic restrictions on charging or receiving interest, the banks have used considerable ingenuity in responding to the situation. The acceptable procedure for the banks is to assume an equity position in loans or to grant loans which provide only for cost recovery and a nominal service fee, as opposed to provision of interest-paying loans. The banks, however, offer competitive interest rates on riyal deposits in order to hold and increase their deposit accounts. They also accept deposits in other currencies which yield interest according to the prevailing international rates.

Charges for short-term loans under 1 year were, in the past, based on the borrower's personal standing rather than the duration of the loan or the prevailing rates of interest on the riyal market. Medium-term loan rates have fluctuated between 7 percent and 10 percent annually with the combination of a low-cost source of funds and flexible rates resulting in loan rate spreads often exceeding 4 percent. Consequently, most Saudi accounts have earned low yields even when the rate of inflation has been in excess of 15 percent. Between 1979 and 1981 the cost of funds became less favorable as the commercial banks encountered an almost complete reversal of the earlier low-interest rates in the kingdom. By the end of 1982 and into 1983, however, the gradual drop in international interest rates began to effect a decline in riyal rates.

Despite a reduction in the availability of low-cost funds and relatively high reserve requirements, the commercial banks in Saudi Arabia generally have sufficient loanable funds, except when SAMA deliberately tightens credit and effectively eliminates the interbank funds market. During the 1979 liquidity crisis, for example, daily riyal rates rose to over 25 percent, creating a severe temporary cash problem. When the banks have difficulty in finding the necess-

ary cash they often have to borrow riyals offshore where rates may be considerably above those prevailing in the kingdom. In spite of this risk the profit potential, combined with the returns available on investments, continues to effect a dynamic banking environment.

The loss of a low-cost funds source and the stringent reserve requirements have forced the commercial banks to adapt new service strategies and to adjust loan portfolios. In order to maintain their profit ratios, the banks have increasingly turned to the highly liquid and profitable commerce and trade sector to provide the majority of bank profits. The percentage share of loans to the manufacturing and process sector declined from 15.5 percent in 1975 to 7.8 percent in 1980, and a large share of loan revenues continue to come from the short-term trade finance sector. Since the manufacturing sector must, however, obtain term loans in order to continue the economic diversification effort, term credits must come from the government. An additional concern is that of holding loan and deposit funds in the country. Arbitrage opportunities exist for businessmen because of the difference between interest rates outside and inside the kingdom. Local interest rates on deposits in late 1981 were 7–8 percent for National Commercial Bank and Riyad Bank and 8–10 percent for the Saudized banks, well below Bahrain and international interest rates, which ranged between 14.5 percent and 17.5 percent, according to local and offshore bank published daily rates. As a result, the funds from many government development loans and 'miscellaneous' bank loans may have been drawn into the international money and capital markets.

Liquidity is an important aspect of the development of any banking system and, as will be noted in greater detail in Chapter 4, this is of critical concern to SAMA and the Saudi Arabian banking system. Generally, the problems with liquidity in Saudi Arabia include a recognition that for religious and other reasons the banking system is limited in the degree of liquidity which can be assured at any given point in time. Further, the lack of secondary financial markets in Saudi Arabia precludes another avenue of liquidity. Finally, the availability of a lender of last resort, usually in the form of a central bank authority with the discount window option available, does not exist in the kingdom since SAMA does not possess the authority to engage in this type of support for various reasons. Thus, in order to meet the necessary liquidity requirements, the government has provided SAMA with the authority, through the Banking Control Law of 1966, to establish as necessary strict liquidity reserve restrictions which perform an important role in the stability and performance of the commercial banks.

Overall Balance Sheet Growth

Despite the limitations imposed by the Banking Control Law, discussed in Chapter 4, balance sheet growth in the kingdom's banking industry has been dramatic. By the end of fiscal year 1981–1982 (1401–1402 AH),[10] the number of commercial bank branches operating in the kingdom had risen to 365, as

compared to 98 in fiscal year 1976–1977, at the start of bank Saudization, as can be seen in Tables 3.1 and 3.2. The balance sheet aggregates of the commercial banks, while not as large as either SAMA or the government specialized credit agencies, have shown steady growth since Saudization. (See Table 3.3.)

The balance sheet aggregate totals of the commercial banks, SAMA, and the specialized credit or funding agencies show that the financial system has mirrored the overall growth of the economy since 1973. Appendix D lists the funding agencies and states their objectives. Individually, the specialized credit agencies, as the government's main tool in long-term capital development and economic diversification, experienced the largest increase. The specialized credit agencies relaxed the shift towards private sector credit development. SAMA monetary growth also slackened during the 1979–1980 period as commercial bank reserve requirements were lowered in response to the pressure on bank deposits, and the government experienced a current accounts deficit. The commercial banks also have grown steadily, pausing only during the 1977–1979 period, largely as a result of the expansion in bank credit requirements for construction and commerce which the banks could meet due to stringent reserve requirements and high international interest rates which drew deposits out of the kingdom.

While all sectors of the financial system have experienced considerable growth, the commercial banks have not participated as much in the total balance sheet growth as planned, falling from a 43 percent growth in 1981 to an 18 percent growth in 1982, a reflection of the argument that the government specialized credit agencies point the direction for commercial bank credit policy. The magnitude of this point is highlighted by the fact that commercial bank balance sheet aggregates grew by an average compound annual increase of 36 percent, while the specialized credit agencies grew by 79 percent per year. Further, the percentage of financial system balance sheet totals controlled by the commercial banks should be growing, but this is not happening, with the commercial banks maintaining control of approximately 18 percent of the total. To elaborate, during the 1978–1981 period, some of the kingdom's major infrastructure and private sector development occurred, but the commercial bank share of the totals held at 17–18 percent, an indication that the banks were not becoming increasingly involved in the kingdom's private sector economic diversification effort. While blame for this performance may be found in many factors outside the control of the banks, on the other hand the banks have had tremendous profit opportunities which also enabled them to build an equity base for future banking development.

In order to understand better the successes and failures which the banking system has experienced in meeting its challenges and opportunities, it is appropriate to discuss the activity trends identifiable in the financial statements of the Saudized commercial banking system. Table 3.4 details deposit, asset, equity, loan, and profit data indicating that, in general, total commercial bank activity has increased steadily, with the largest increases occurring between 1978 and 1981. The surge of monetization achieved with bank Saudization has

Table 3.3 Financial system balance sheet aggregates* (1973–1982 hijra fiscal years) (billions SR)

										Average compound annual
	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982
SAMA	17	24	30	36	43	52	61	70	82	94	21%
Commercial banks	14	20	28	39	56	77	98	114	163	193	36%
Specialized credit agencies	1	2	3	4	5	7	9	14	20	29	79%
Total	32	46	61	79	104	136	168	198	265	316	33%

*Figures are rounded.

	1973	1974	1975	1976	1977	1978	1979	1980	1981	1982	Annual % growth**
Commercial banks	5.3	7.6	11.8	21.7	35.2	52.5	52.6	65.5	93.6	110.3	
SAMA			130	170.6	197.4	197.1	185.6	222.3	320.1	434.6	
Specialized credit agencies*	0.5		1.1	7.4	29	46.7	63.8	86.9	107.6	114.5	
Total			142.9	199.7	261.6	296.3	302	374.7	521.3	659.4	
Percentage growth											
Commercial banks		43.40	55.26	83.90	62.21	49.15	0.19	24.52	42.90	17.84	36
SAMA				31.23	15.71	−0.15	−5.83	19.77	43.99	35.77	20
Specialized credit agencies*				572.73	291.89	61.03	36.62	36.21	23.82	6.41	79
Total				39.75	31.00	13.26	1.92	24.07	39.12	26.49	24
Percentage of total											
Commercial banks			8.26	10.87	13.46	17.72	17.42	17.48	17.96	16.73	
SAMA			90.97	85.43	75.46	66.52	61.46	59.33	61.40	65.91	
Specialized credit agencies*			0.77	3.71	11.09	15.76	21.13	23.19	20.64	17.36	
			100	100	100	100	100	100	100	100	

Sources: Compiled from *SAMA Annual Report, 1398* (1978), p. 49, and *SAM. Annual Report, 1401* (1981), p. 28, and *SAMA Statistical Summary 1402* (1982), pp. 50–51, 55, 63.

* Cumulative disbursements, based on assumption of no loan repayments.

** Commonly utilized analytical factor based on the formula: $\frac{FV/N}{PV} - 1 \times 100$; where PV equals the initial value in the series, F the final value in the series, and N the number of years in the series.

significantly affected the nature of the growth process. While the rate of asset growth for some banks levelled off after the initial surge, other balance sheet categories continued to grow through 1982, approximately doubling, and profits increased almost seven-fold. Unfortunately, the reader who wishes to coordinate the SAMA and individual bank statements will find that the individual statements do not add to the SAMA total due to past consolidation with foreign parent banks, the unavailability of specific financial details for several banks, and the fact that SAMA makes periodic adjustments in its statements to reflect changes in reporting policies.

Deposit Growth

Looking more closely at the sources of commercial bank growth and liquidity, it is clear that in absolute terms deposit activity has provided the main growth impetus, contributing SR 89.3 billion, or 81 percent, of total commercial bank liabilities of SR 110.3 billion at the end of fiscal year 1982. (See Table 3.4.) This

Table 3.4 Aggregate commercial banks: balance sheets, 1973–1982 hijra fiscal years (billions SR)

	1973	*1974*	*1975*	*1976*	*1977*	*1978*	*1979*	*1980*	*1981*	*1982*
ASSETS										
Cash	0.1	0.2	0.2	0.4	0.7	0.8	1.2	1.3	1.3	1.5
SAMA deposits										
Current	1.8	1.6	2.0	3.0	4.6	6.4	4.7	4.0	3.6	4.8
Statutory	0.5	0.8	1.3	2.6	7.0	11.1	11.5	3.7	3.0	3.8
Subtotal	2.4	2.6	3.5	6.0	12.3	18.3	17.4	9.0	7.9	10.1
Foreign assets	0.7	1.4	2.4	5.4	9.4	14.7	13.0	24.0	41.0	53.6
Loans/investments	1.8	3.2	5.4	8.5	8.4	11.2	19.7	29.2	40.3	46.6
Other assets	0.4	0.4	0.5	1.8	5.1	8.3	2.5	3.3	4.4	0.0
Total	5.3	7.6	11.8	21.7	35.2	52.5	52.6	65.5	93.6	110.3
LIABILITIES										
Deposits										
Demand dep.	2.3	3.2	5.6	11.0	17.6	27.3	29.5	30.5	37.3	46.2
Quasi-mon.										
Time dep.	0.8	0.9	1.5	1.6	1.8	3.1	4.2	9.5	13.1	26.6
Other	0.7	1.3	1.9	3.3	4.3	5.3	6.7	7.5	11.0	16.5
Subtotal	3.8	5.4	9.0	15.9	23.7	35.7	40.4	47.5	61.4	89.3
Foreign liab.	0.4	0.9	1.1	2.7	4.0	4.8	5.7	5.9	8.5	7.1
Capital/res.	0.2	0.3	0.5	0.8	1.1	1.4	2.0	3.5	4.8	6.6
Other liab.	0.9	1.0	1.2	2.3	6.4	10.7	4.5	8.6	18.9	7.3
Total	5.3	7.6	11.8	21.7	35.2	52.6	52.6	65.5	93.6	110.3

Sources: Compiled from *SAMA Annual Report, 1398* (1978), pp. 128–131; *SAMA Annual Report, 1401* (1981) pp. 129–130; *SAMA Statistical Summary 1402* (1982) pp. 14–17.

compares with an 84 percent ratio for the ten largest banks in the world in 1981.[11] Commercial bank total deposit liabilities have increased each year, but the rate of growth was most significant between 1973 and 1978. According to SAMA commercial bank deposit data, the rate of increase slowed during 1979 and 1980 before again resuming the pace. The decline in the growth rate of deposits was attributable to a combination of the reduced generation of liquidity in the economy caused by a slowdown in government expenditures, a private sector balance of payments deficit, and high external interest rates. The high growth rates during 1979–1981 occurred largely as a consequence of higher oil prices, increased monetization of the financial system, and expansion of the banking system resulting from bank Saudization.

The major changes taking place in the financial position and performance of the banks in Saudi Arabia can be identified with the relative growth, composition, and utilization of bank deposits. These are among the most dynamic and changeable aspects in any bank's growth and consequently are significant indicators of the performance of the management because they can have a considerable impact on the larger total balance sheet, income statement, and funds flow performance of the bank. The overall changes in the deposit structure of the Saudi and Saudized banks are significant because they show steady growth, but the rate of growth may be stabilizing.

The major deposit account trends are identifiable in an analysis of Table 3.5, which indicates that the kingdom is becoming monetized, and bank customers increasingly are sensitive to the movement of international interest rates. The monetization trend is identified partially with demand deposit growth and branch bank development. International interest rate sensitivity is evidenced by the relatively sharp increase in time deposits returning to Saudi Arabia as international rates began to drop in 1982. Also, the continued increases in other quasi-monetary activity, primarily contra account deposits, is an indication that construction and trading activities continued to be the primary internal economic growth sectors in the economy through 1982. Contra accounts, which are excluded from the following analysis, are below the line assets which are not accountable in normal financial analysis. Contra accounts include various commitments and contingent liabilities such as lease commitments, commitments to extend credit, future foreign exchange contracts, letters of credit, and guarantees.

Table 3.6 focuses on the changing composition of the deposit structure, which is beginning to shift away from a high percentage of demand deposits towards more stable time deposits. Table 3.6 shows that between 1973 and 1982 demand deposits increased by an average annual compound rate of 36 percent, and total deposits by 38 percent. This indication of support for the banking system and the increasing sophistication of bank customers presents both positive and negative benefits for the banks. The most important positive development has been that a larger portion of the revenues generated in Saudi Arabia is made available for potential investment in the kingdom. This is an especially important factor for time deposits since, as the percentage share for

Table 3.5 Aggregate commercial banks: balance sheet annual percentage changes, 1973–1982 hijra fiscal years

	1974	*1975*	*1976*	*1977*	*1978*	*1979*	*1980*	*1981*	*1982*
ASSETS									
Cash	100	0	100	75	14	50	8	0	15
SAMA deposits									
current	−11	25	50	53	39	−27	−15	−10	33
statutory	60	63	100	169	59	4	−68	−19	27
Subtotal	8	35	71	105	49	−5	−48	−12	28
Foreign assets	100	71	125	74	56	−12	85	71	31
Loans/investments	78	69	57	−1	33	76	48	38	16
Other assets	0	25	260	183	63	−70	32	33	+100
Total	43	55	84	62	49	0	25	43	18
LIABILITIES									
Deposits									
Demand dep.	39	75	96	60	55	8	3	22	24
Quasi-mon.									
Time dep.	13	67	7	13	72	35	126	38	103
Other	86	46	74	30	23	26	12	47	50
Subtotal	42	67	77	49	51	13	18	29	45
Foreign liab.	125	22	145	48	20	19	4	44	−16
Capital/res.	50	67	60	38	27	43	75	37	38
Other liab.	11	20	92	178	67	−58	91	120	−61
Total	43	55	84	62	49	0	25	43	18

Sources: Compiled from *SAMA Annual Report, 1398* (1978), pp. 128–131; *SAMA Annual Report 1401*, (1981), pp. 129–130; *SAMA Statistical Summary 1402* (1982), pp. 14–17.

time deposits increases, loan terms also may be extended to the benefit of the development sectors of the economy.

Long-term deposits normally are beneficial for the banking and capital markets, not only because they enable the banks to extend longer-term credit facilities and consequently perform an expanded economic development role, but they also carry the implication of interest or service charges which in recent years have tended to track with international interest rates. Combined with the fact that time deposit maturities in Saudi Arabia still are short by Western standards, and deposits can move offshore fairly rapidly if the rate spread becomes too significant, the situation should be looked on as difficult for a banking system which has not yet developed the capability to administer an effective long-term credit analysis program.

Study of individual bank annual reports indicates that there is reason for concern about the deposit conditions at some banks. Since SAMA accounting rules do not require individual banks to report publicly on the maturity terms of their deposits, there is no official reported source through which to ascertain whether a bank might have potential liquidity problems. The 100 percent Saudi

Table 3.6 Aggregate commercial banks: deposits composition, 1973–1982 hijra fiscal years (percentage share)

	1973	*1974*	*1975*	*1976*	*1977*	*1978*	*1979*	*1980*	*1981*	*1982*
Demand deposits	61	59	62	69	74	76	73	64	61	52
Quasi-monetary										
Time deposits	21	17	17	10	8	9	10	20	21	30
Other deposits	18	24	21	21	18	15	17	16	18	18
Total	100	100	100	100	100	100	100	100	100	100
AVERAGE COMPOUND ANNUAL % GROWTH (1973–1982)										
Demand deposits										36
Quasi-monetary										
Time deposits										42
Other deposits										38
Total										38
PERCENTAGE CHANGE										
Demand deposits		39	75	96	60	55	8	3	22	24
Quasi-monetary										
Time deposits		13	67	7	13	72	35	126	38	103
Other deposits		86	46	74	30	23	26	12	47	50
Total		42	67	77	49	51	13	18	29	45

Sources: Compiled from *SAMA Annual Report, 1397* (1977), p. 22, and *1401* (1981), p. 32.

banks have a natural advantage in obtaining deposits, especially the highly sought-after long-term government agency deposits. According to Table 3.7, the degree of Saudi bank control of bank deposits in the kingdom is reflected in the operations of the National Commercial Bank, with SR 27.0 billion in deposits during October 1980, representing 39.1 percent of all commercial bank deposits. NCB and Riyad Bank together controlled 55 percent of total kingdom commercial bank deposits during 1980 and 1981.

Since 1981 several Saudized banks have experienced considerably higher rates of growth in deposits. One reason given for this growth is that Bank Al-Jazira, the Arab National Bank, and the Saudi Cairo Bank, with generally lower cost of service bases than the other Saudized banks, have increased time deposits but at the price of lower profits as a consequence of the relatively higher interest rates paid on the newly acquired deposits. During 1981 the Saudi Dutch Bank experienced the highest rate of increase, 54 percent, followed by Bank Al-Jazira with a 47 percent increase. The Saudi American Bank, despite considerable success in other areas, increased deposits by only 2 percent in 1981. However, during 1982, it made the largest gain in deposits, 48 percent, as a result of effective market targeting and customer computer

Table 3.7 Commercial banks: total deposits, 1978–1982 (millions SR and percentage growth)

	1978	*1979*	*1980*	*1981*	*1982*
National Commercial Bank	19 152	24 300 27%	26 967 11%	32 695 21%	45 369 39%
Riyad Bank	6 524	8 477 30%	11 011 30%	17 875 62%	19 069 7%
Saudi American Bank			6 277	6 431 2%	9 526 48%
Saudi French Bank	1 650	2 146 30%	4 790 123%	5 102 7%	7 312 43%
Saudi Dutch Bank	1 869	2 369 27%	2 965 25%	4 557 54%	5 769 27%
Saudi British Bank	1 501	2 264 51%	3 793 68%	4 366 15%	5 113 17%
Arab National Bank		3 241	2 871 −11%	3 593 25%	5 233 46%
Bank Al-Jazira	1 310	1 673 28%	2 003 20%	2 951 47%	4 000 36%
Saudi Cairo Bank		2 385	4 234 78%	5 680 34%	

Sources: Compiled from bank annual reports.
* Data as of end of hijra calendar year.

links. Thus, while the 100 percent Saudi-owned banks still control the majority of existing private deposits and most of the new growth in deposits, the newly Saudized banks gradually are increasing deposit growth. Consequently, aggressive and competitive management and marketing programs will be the major factors in obtaining future deposits which will become longer-term as the economy stabilizes.

Equity Growth

Equity is made up of capital, reserves, and retained earnings and is critical in the long-term success of a bank. The capital portion of equity is essential for a bank to attract the other borrowed funds, primarily deposits required to support its business. Capital increases represent the confidence of its owners, indicating that the bank will be able to continue to perform its banking activities into the future.

In Saudi Arabia paid-in capital increases are approved by SAMA. However, SAMA only infrequently grants authorized capital increases, and as a result the most important source of new capital is reserves. The capital base is important, because the return on the capital base provides an indication of how well a bank's programs can be sustained as well as serving as a cushion against

temporary losses or ultimate protection in the event of liquidation. In a Western economy capital serves as a link between financial markets and a bank's profitability. Generally, the capital and equity positions of the individual Saudi commercial banks have also increased more than other factors in the kingdom's bank growth, due largely to Saudization and the increase in profits and reserves. Despite the fact that the major bank equity increases occurred during the immediate Saudization period, there still is considerable room for further capital and equity growth due to the fact that the economy may still be underbanked. Accordingly, one of the most critical factors in the ability of a bank in Saudi Arabia to grow is the on-going statutory reserve accumulations called for in Article 13 of the Banking Control Law: 'Every bank shall before declaring distribution of any profits, transfer a sum equal to not less than 25 percent of its net profits, to the statutory reserve, until the amount of that reserve equals as a minimum the paid-up capital.' This is a focal point for bank performance analysis since the bank contributions to the statutory reserve and the general reserve build a future equity base and earning power.

The capital accounts of the commercial banks, consisting of paid-up or invested capital, statutory reserves, and other reserves, have shown continuing growth, reaching SR 6.6 billion in 1982, and resulting in an average compound annual growth of 42 percent between 1973 and 1982. (See Table 3.8.) The primary factors in this development are the infusion of new capital during bank Saudization and the general increase in banking activity and profits, providing a substantial financial cushion for the future. Aggregate capital and reserves growth is a reflection of bank profit growth as much as equity capital development. Over the last several years the basic means for bank equity capital expansion has been through the accumulation of the SAMA statutory reserve, which is derived from the Banking Control Law and the Commercial Law. The basis of the reserve accumulation rationale is Articles 6 and 7 of the Banking Control Law and the Commercial Law which established a 10 percent reserve requirement for all corporations. Accordingly, 25 percent of the bank's annual income, after Zakat, is placed in the non-interest bearing SAMA statutory reserve until the reserve is equal to the paid-up capital of the bank. This reserve account is not available for distribution. Since increases in capital are regulated by SAMA, this is the primary means of increasing capitalization. SAMA

Table 3.8 Commercial banks: equity growth, 1973–1982 hijra fiscal years (billions SR)

	1973	*1974*	*1975*	*1976*	*1977*	*1978*	*1979*	*1980*	*1981*	*1982*
Capital & reserves	0.2	0.3	0.5	0.8	1.1	1.4	2.0	3.5	4.8	6.6
Percentage change		50	67	60	38	27	43	75	37	38
Average compound Annual % increase (1973–1982)										42

Sources: Compiled from *SAMA Annual Reports, 1398* (1978), p. 38, and *1400* (1980), p. 49.

reporting rules do not identify the separate capital and reserves account portions of the aggregate totals, leaving the analyst to work with individual bank reports to identify the development of and changes in the reserve accounts. Thus, individual bank profits are prime indicators of bank capitalization growth.

According to Table 3.9, the equity (capital plus reserves) position of the individual commercial banks indicates that while the Saudi banks have the majority control of the total equity in the Saudi banking system, approximately 60 percent in 1981, the profit growth rates of the Saudized banks have enabled them to increase their retained earnings and reserves faster than the Saudi banks. For example, the Arab National Bank, which experienced high profit growth rates during 1981 and 1982, also has been able to increase its equity base at the most consistent and rapid rate of growth of any of the commercial banks. The Saudi American Bank has increased its equity position at approximately the same rate as the Arab National Bank despite having a larger initial equity base. Examination of the bank annual reports shows that reserves generally comprise 98–99 percent of the equity for the Saudi banks, the growth rates of the Saudized banks have drawn a considerably larger capital base, and the profit results of these banks are rapidly raising the reserve levels and lowering the percentage share of reserves in the total equity base. The increase in reserves is also providing an internal financing source along with considerable depositor and shareholder protection.

Asset Growth

Effective growth of a commercial bank is also measured by the growth of its assets. Total asset growth provides an overall indication of the rate of development of the primary profit-making vehicles, normally loans and investments. There has been significant growth over the past few years, with the assets of the aggregated Saudi banks, according to Table 3.10, growing from SR 5.3 billion in 1973 to SR 110.3 billion in 1982. However, the rate of increase has moderated since 1979, experiencing zero percent growth in 1979, 25 percent in 1980, 43 percent in 1981 and 18 percent in 1982. The primary area of change has been in the level of SAMA commercial bank non-interest bearing statutory deposits, which in 1979–1980 dropped from SR 11.5 billion to SR 3.7 billion as a result of the decrease in statutory deposit requirements on demand deposits (from 10 percent to 7 percent) and time deposits (5 percent to 2 percent). This allowed the banks to place more of their asset base in a position to earn potential profits.

Individually, Saudi commercial bank asset growth has been most significant for the banks of non-Western origin (the National Commercial Bank, Riyad Bank, the Arab National Bank, Bank Al-Jazira, and the Saudi Cairo Bank) which have the natural advantage of a strong local tie to the Arab population in the kingdom. For example, their asset growth rates ranged between 26 and 65 percent in 1981. (See Table 3.11.) This compares very favorably with the

Table 3.9 Commercial banks: capital and reserves, 1978–1982 (millions SR)

	1980	1981	% growth	1982	% growth
National Commercial Bank*					
Capital	30	30	0	30	0
Total reserves	1 548	1 970	27	2 370	20
Total	1 578	2 000	27	2 400	20
Reserves/capital	98%	99%	0	99%	0
Riyad Bank					
Capital	50	50	0	50	0
Total reserves	1 275	1 750	37	2 250	29
Total	1 325	1 800	36	2 300	28
Reserves/capital	96%	97%	1	98%	1
Saudi American Bank					
Capital	300	300	0	300	0
Total reserves	85	305	259	584	91
Total	385	605	57	884	46
Reserves/capital	22%	50%	128	66%	31
Saudi French Bank					
Capital	200	200	0	200	0
Total reserves	37	164	343	400	144
Total	237	364	54	600	65
Reserves/capital	16%	45%	189	67%	48
Saudi Dutch Bank					
Capital	210	210	0	210	0
Total reserves	83	160	93	229	43
Total	293	370	26	439	19
Reserves/capital	28%	43%	53	52%	21
Saudi British Bank					
Capital	300	300	0	300	0
Total reserves	71	132	86	210	59
Total	371	432	16	510	18
Reserves/capital	19%	31%	60	41%	35
Arab National Bank					
Capital	150	150	0	150	0
Total reserves	120	300	150	510	70
Total	270	450	67	660	47
Reserves/capital	44%	67%	50	70%	16
Bank Al-Jazira					
Capital	100	100	0	100	0
Total reserves	58	119	105	153	29
Total	158	219	39	253	16
Reserves/capital	37%	54%	48	60%	11
Saudi Cairo Bank					
Capital	150	150	0		
Total reserves	85	172	102		
Total	235	322	37		
Reserves/capital	36%	53%	48		

Sources: Compiled from bank annual reports.
* Data as of end of hijra calendar year.

Table 3.10 Aggregate commercial banks: total assets, 1973–1982 hijra fiscal years (billions SR)

	1973	*1974*	*1975*	*1976*	*1977*	*1978*	*1979*	*1980*	*1981*	*1982*
Cash	0.1	0.2	0.2	0.4	0.7	0.8	1.2	1.3	1.3	1.5
SAMA deposits										
Current	1.8	1.6	2.0	3.0	4.6	6.4	4.7	4.0	3.6	4.8
Statutory	0.5	0.8	1.3	2.6	7.0	11.1	11.5	3.7	3.0	3.8
Subtotal	2.4	2.6	3.5	6.0	12.3	18.3	17.4	9.0	7.9	10.1
Foreign assets	0.7	1.4	2.4	5.4	9.4	14.7	13.0	24	41.0	53.6
Loans/investments	1.8	3.2	5.4	8.5	8.4	11.2	19.7	29.2	40.3	46.6
Other assets	0.4	0.4	0.5	1.8	5.1	8.3	2.5	3.3	4.4	0.0
Total	5.3	7.6	11.8	21.7	35.2	52.5	52.6	65.5	93.6	110.3
Percentage Growth		43	55	84	62	49	0	25	43	18

Sources: Compiled from *SAMA Annual Report, 1398* (1978), pp. 128–131, *SAMA Annual Report, 1401* (1981), pp. 129–130; *SAMA Statistical Summary 1402*, (1982), pp. 14–17.

Table 3.11 Commercial banks: total assets, 1978–1982 (millions SR and percentage change)

	1978	*1979*	*1980*	*1981*	*1982*
National Commercial Bank*	20 995	26 301	31 054	41 564	51 137
		25%	18%	34%	23%
Riyad Bank	10 280	14 256	14 669	24 178	26 605
		39%	3%	65%	10%
Saudi American Bank			7 039	7 581	10 906
				8%	44%
Saudi French Bank	2 188	3 271	5 686	6 282	8 725
		49%	74%	10%	39%
Saudi Dutch Bank	2 079	2 797	3 566	5 478	7 018
		35%	27%	54%	28%
Saudi British Bank	1 999	2 869	4 347	5 102	6 187
		44%	52%	17%	21%
Arab National Bank		3 680	3 281	4 118	6 198
			−11%	26%	51%
Bank Al-Jazira	1 515	1 844	2 297	3 184	4 400
		22%	25%	39%	38%
Saudi Cairo Bank		2 922	5 592	8 329	
			91%	49%	

Sources: Compiled from bank annual reports.
* Data as of end of hijra calendar year.

experience of the top ten banks in the world which increased their assets between 2.9 percent and 26.8 percent in 1981. While the Western origin banks also have done well in asset growth, they have been constrained by the Saudization process and by building the management team and branch system required to obtain deposits and carry out effective lending operations.

Clearly, the asset growth rates achieved by the Saudi commercial banks have exceeded those of most of the other top 50 banks in the world over the past several years. The asset growth rates of the Saudi banks have ranged from 3 percent for Riyad Bank in 1980, a year of high international interest rates, to 91 percent for the Saudi Cairo Bank. The National Commercial Bank, the largest and oldest Saudi bank, has maintained fairly steady growth rates between 18 and 34 percent, and none of the banks thus far has lagged in asset growth.

Loan and Investment Growth

Domestic loans and investments traditionally have represented the main commercial bank asset activity, but in recent years foreign loans, investments, and deposits have increased steadily. There was, however, a pronounced increase in bank claims on the private sector during 1978–1979, attributable mainly to a decline in overall government credit agency disbursements as the actual expenditures of the second development plan exceeded planned expenditures. In addition, a slowdown in government disbursements and an increase in requirements for financing inventories in the commercial sector tended to raise the demand for commercial bank bridge or seasonal financing. Commercial bank cash on hand and balances with SAMA, which increased prior to 1978–1979, declined thereafter, a reflection of the lower reserve requirements for the commercial banks.

SAMA consolidated data shows that while domestic loans and investments in Saudi Arabia have grown considerably between 1973 and 1980 (see Table 3.5), the overall trend is downward, based on a combination of factors including infrastructure completion, lack of sufficiently trained technicians and managers, along with a continued overemphasis on the oil and trade economic sectors as the major elements in the growth process. Further, the banks have been conservative in their lending and investment activities since they are prevented from enforcing mortgage collateral arrangements for term loans and can obtain high short-term rates of return on trade credit and construction financing. Because the Saudized foreign banks were not allowed to open new branches or increase their capital base during the pre-Saudization period, they lagged behind in profitability and in expanding the local loan base. Consequently, the 100 percent Saudi-owned commercial banks have continued to control the bulk of commercial bank loans. However, since 1980 the growth rate of loans and private sector investments has declined, and has effected a decline in loans as a percentage of total balance sheet composites, reflecting hesitation on the part of borrowers and lenders.

A key factor in the shifts in loan activity is the government diversification drive of the late 1970s which effected an increase in the availability of low-cost medium- and long-term loans from the specialized credit agencies. In response to the government incentive, bank loans to manufacturing and processing industries initially increased, but have decreased, as a percentage of the total, since 1975, according to Table 3.12. In addition, the government has almost totally financed the development of the primary industry sector, with most of the joint foreign partner financing done overseas. The hope thus is that with the expansion of commercial bank services to specific market segments, economic sector credit distribution eventually could shift in favor of secondary industry, services, finance, transportation, and communications.

Two other factors behind the decline in the rate of loan activity are the general slowdown in government spending and construction and the SAMA regulations of early 1983 on offshore bank loan syndications. The government spending and construction slowdown is based on a direct relationship between oil revenues and government spending, and the syndication restrictions were promulgated in order to prevent unsound alliances and riyal internationalization. The effect of the syndication rules is that some loan business may be brought back to Saudi Arabia, but they do not deal with the basic problem of the inability of Saudi banks to compete effectively with the offshore banking units which has in the past tended to move loan activity and profits offshore.

Table 3.12 Commercial banks: loans, 1978–1982 (millions SR and percentage change)

	1978	*1979*	*1980*	*1981*	*1982*
National Commercial Bank*	6 677	8 708 30%	12 245 41%	16 144 32%	19 783 23%
Riyad Bank	2 412		5 418	8 389 55%	10 818 29%
Saudi American Bank			4 302	4 042 −6%	5 178 28%
Saudi French Bank	1 215	1 587 31%	3 897 146%	5 365 38%	7 716 44%
Saudi Dutch Bank	790	1 427 81%	1 929 35%	2 149 11%	2 868 33%
Saudi British Bank	624	1 273 104%	1 762 38%	2 177 24%	2 514 15%
Arab National Bank			1 455	1 570 8%	2 042 30%
Bank Al-Jazira	388	872 125%	1 107 27%	1 284 16%	1 700 32%
Saudi Cairo Bank		1 158	2 850 146%	3 058 7%	

Sources: Compiled from bank annual reports.
* Data as of end of hijra calendar year.

The situation is a result of the overpowering role of the Saudi Arabian government in the economy, controls on mortgages, the lack of a lender of last resort for the banking system, and the possible future of the economy, all of which continue to delay substantial loan expansion and are driving potential loan funds into foreign banks and other foreign investments.

Foreign Deposits and Investments

Bank acquisitions of foreign assets, primarily overseas bank deposits and overseas investments, are the second most significant utilization of deposited funds. For a number of reasons this net outbound flow of funds has increased significantly during the study period (1973–1982). Rising rapidly during the 1975–1978 period, it declined in 1978–1979 as banks drew down both their riyal and foreign currency claims on banks abroad to finance the growing demand for import payments and the expanded demand for bank credit in general. (See Tables 3.4 and 3.5.) Since 1979 increasing domestic incomes, combined with tighter rules on mortgage arrangements in the kingdom, have operated to effect an increase in the acquisition of foreign assets. The only slowdowns have occurred when the import–export balance effected a drawdown of foreign assets. While the composition of the foreign asset accounts is not detailed in the SAMA or bank annual reports, it is believed that the demand for these accounts has increased in almost direct proportion to the increase in the overall funds flow, and even during the slowdown in oil demand (1982–1983) the acquisition of foreign assets has continued at a high rate.

For the individual banks, the acquisition of foreign assets, in absolute and percentage growth, provides a somewhat more detailed indication of the rate of growth for foreign assets and liabilities. Considerably surpassing any anticipated need for balances to support imports, the main purchasers of foreign assets are, according to Table 3.13, the two largest banks in Saudi Arabia, the National Commercial Bank and Riyad Bank. These two banks controlled 68 percent of total Saudi commercial bank net foreign assets in 1980 and 1981, surpassing their percentage share of total assets or total deposits. Foreign asset purchases at these and other banks have continued despite the downward trend in loan activity even though the banks have registered increases in reserves, equity, and profits. For example, the National Commercial Bank private sector loans and advances increased only 23 percent in 1982 despite a 39 percent increase in deposits and a 39 percent increase in net foreign assets.

Structural Analysis of Deposits, Equity, and Assets

Structural analysis involves consideration of the financial ratios which compare various banking growth ratios, for debt (deposits), assets, and equity. Since a major principle of the Western banking system is financial leverage, or trading on the equity, the financial ratios indicating bank growth can be more indicative of performance than percentage growth comparisons. One of the prime

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Table 3.13 Commercial banks: net foreign assets, 1978–1982 (millions SR)

	1980	*1981*	*1982*
National Commercial Bank*			
Assets	9 624	16 247	18 838
Liabilities	2 665	5 527	3 913
Total	6 959	10 720	14 925
% growth		54	39
Riyad Bank			
Assets	4 993	12 501	10 412
Liabilities	117	781	439
Total	4 876	11 720	9 973
% growth		140	−15
Saudi American Bank			
Assets	1 759	2 046	4 220
Liabilities	609	438	142
Total	1 150	1 608	4 078
% growth		40	154
Saudi French Bank			
Assets	968	181	228
Liabilities	163	215	610
Total	805	−34	−382
% growth		−104	1 024
Saudi Dutch Bank			
Assets	1 228	2 721	3 131
Liabilities	334	632	626
Total	894	2 089	2 505
% growth		134	20
Saudi British Bank			
Assets	1 728	2 065	2 799
Liabilities	224	126	76
Total	1 504	1 939	2 723
% growth		29	40
Arab National Bank			
Assets	1 144	1 485	6 198
Liabilities	116	129	317
Total	1 028	1 356	5 881
% growth		32	334
Bank Al-Jazira			
Assets	783	1 357	2 200
Liabilities	334	277	
Total	449	1 080	
% growth		141	
Saudi Cairo Bank			
Assets	1 499	3 908	
Liabilities	954	1 656	
Total	545	2 252	
% growth		313	

Source: Compiled from bank annual reports.
* Data as of end of hijra calendar year.

requisites for profitable commercial bank operations is a favorable leverage or equity trading situation. Effective leverage activity requires that debt be used in the capital structure to increase shareowner return, assuming that the return on debt investment is greater than the cost of borrowing the funds. This concept can work well in good economic times but works to the detriment of the bank in poor economic conditions. In the Saudi commercial banking system equity growth has been more rapid than debt growth over the past few years as a combination of Saudization and SAMA restrictions on dividend and reserve payments have added substantially to the capital base of the banks. The average ratios for all the banks, when compared with those of banks outside Saudi Arabia, clearly indicate the degree to which the economy was underbanked during the key development years, enabling the banks to earn maximum profits and build their asset and equity positions despite various internal and external restrictions.

Debt to Equity Ratio

Since leverage is an integral element in the growth of the Western banking system, it is appropriate that debt (deposits) be used as a major aspect of the profit and growth process. In Saudi Arabia where the internal development has been substantial, but volatile and erratic, the banking system and SAMA have maintained a high percentage of equity to supply extra stability to the system in case of future rapid shifts in the economy.

While no specific guidelines exist for the 'proper' debt–equity ratio, there are general parameters based on what well-managed banks among the best in profits and growth have experienced. The ten largest banks in the world in 1980 had average debt–equity ratios which ranged from 1.0 to 5.9 percent. This compares with the Saudi commercial banks in which, according to Table 3.14, the 1979 ratios were a high of 12.07 percent for the Saudi French Bank to a low of 4.60 for Bank Al-Jazira. While there are a number of reasons for the banks in Saudi Arabia to operate with higher ratios, it is also true that by any standards they have extremely strong debt–equity ratios. In fact, during 1981 and 1982 most of the Saudized banks actually increased their debt equity ratios, increasing equity at a faster pace than deposits.

Capital Ratio

The capital ratio is the other major asset–equity based ratio, providing a measure of total equity to assets, excluding contra accounts. The capital ratio provides a measure of the bank's ability to generate additional capital funds, with the 50 largest banks in the world experiencing an average capital ratio of only 3.49 compared with 3.57 in 1979. (See Table 3.15.) The Saudi banks, meanwhile, experienced capital ratios of between 4.13 and 9.51 in 1979 and between 4.22 and 9.03 in 1980. As a group, the commercial banks of Western origin were the most successful at holding and improving their capital ratios

Table 3.14 Commercial banks: debt to equity ratio, 1978–1982 (millions SR)

	1978	*1979*	*1980*	*1981*	*1982*
National Commercial Bank*					
Debt	19 152	24 300	26 967	32 695	45 369
Equity	698	1 178	1 578	2 000	2 400
Ratio	3.64	4.85	5.85	6.12	5.29
Riyad Bank					
Debt	8 327	11 140	11 011	17 875	19 069
Equity	906	1 341	1 325	1 750	2 300
Ratio	10.88	12.04	12.03	9.79	12.06
Saudi American Bank					
Debt			7 039	7 581	10 906
Equity			385	599	884
Ratio			5.47	7.90	8.11
Saudi French Bank					
Debt	1 650	2 146	4 790	5 102	7 312
Equity	123	259	276	403	600
Ratio	7.45	12.07	5.76	7.90	8.21
Saudi Dutch Bank					
Debt	1 869	2 369	2 965	4 557	7 018
Equity	139	266	293	369	439
Ratio	7.44	11.23	9.88	8.10	6.26
Saudi British Bank					
Debt	1 501	2 264	3 793	4 366	5 113
Equity	110	189	370	432	510
Ratio	7.33	8.35	9.75	9.89	9.97
Arab National Bank					
Debt		3 241	2 871	3 593	5 233
Equity		152	270	450	660
Ratio		4.69	9.40	12.52	12.61
Bank Al-Jazira					
Debt	1 310	1 673	2 003	2 951	4 000
Equity	56	77	157	219	253
Ratio	4.27	4.60	7.84	7.42	6.33
Saudi Cairo Bank					
Debt		2 385	4 234	5 680	
Equity		152	236	321	
Ratio		6.37	5.57	5.65	

Sources: Bank annual reports.
* Data as of end of hijra fiscal year.

Table 3.15 Commercial banks: capital ratio, 1978–1982 (millions SR)

	1978	*1979*	*1980*	*1981*	*1982*
National Commercial Bank*					
Assets	20 995	26 301	31 054	41 564	51 137
Equity	698	1 178	1 578	2 000	2 400
Capital ratio	3.32	4.48	5.08	4.81	4.69
Riyad Bank					
Assets	10 280	14 256	14 669	24 178	26 605
Equity	637	937	1 357	1 840	2 389
Capital ratio	6.20	6.57	9.25	7.61	8.98
Saudi American Bank					
Assets			7 039	7 581	10 906
Equity			385	599	884
Capital ratio			5.47	7.90	8.11
Saudi French Bank					
Assets	2 188	3 271	5 686	6 282	8 725
Equity	123	259	276	403	600
Capital ratio	5.62	7.92	4.85	6.42	6.88
Saudi Dutch Bank					
Assets	2 079	2 797	3 566	5 478	7 018
Equity	139	266	293	369	439
Capital ratio	6.69	9.51	8.22	6.74	6.26
Saudi British Bank					
Assets	1 999	2 869	4 347	5 102	6 187
Equity	110	189	370	432	510
Capital ratio	5.50	6.59	8.51	8.47	8.24
Arab National Bank					
Assets		3 680	3 281	4 118	6 198
Equity		152	270	450	660
Capital ratio		4.13	8.23	10.93	10.65
Bank Al-Jazira					
Assets	1 515	1 844	2 297	3 184	4 400
Equity	56	77	157	219	253
Capital ratio	3.70	4.18	6.84	6.88	5.75
Saudi Cairo Bank					
Assets		2 922	5 592	8 329	
Equity		152	236	321	
Capital ratio		5.20	4.22	3.85	

Sources: Bank annual reports.
* Data as of end of hijra fiscal year.

during 1981 and 1982, but the Arab National Bank, which has climbed from a ratio of 4.13 in 1979 to 10.65 in 1982, has increased its ratio by the largest percentage. Most of the banks have been able to hold their ratios or improve them during the period, with only the Saudi American Bank and the Saudi French Bank registering gains during 1982.

Loans to Deposits Ratio

The main aspect of the deposits structural analysis is the consideration of the important but complex issue of deposit funds utilization. As noted earlier, most revenues for the Saudi banking system are derived from the application of bank deposits to assets which include a combination of foreign and domestic investments and loans. The financial statements of the kingdom's commercial banks indicate that the deposits utilization expansion aspects of the banking system have begun to reflect both problem areas and opportunities as deposits have grown by a 38 percent average annual compound growth rate, according to Table 3.16, but remain potentially one of the most volatile sections of the balance sheet (see Tables 3.4, 3.5, and 3.6). This section will consider the growth of the two main areas of deposits, loans and foreign assets, and it combines the data developed in this section with that derived from the earlier section on the growth of deposits and loans and foreign asset activity to develop several ratios for comparison.

The most important ratios used for judging the deposit utilization capability of a bank are the loans to deposits ratio (loans divided by deposits) and the net foreign assets to deposit ratio. The basic loan–deposit ratio is the most important indicator with respect to the analysis of the loan policies of a bank and success of the Saudi commercial banking system. The loan–deposit ratio shows how fully a bank is 'loaned up'. A high loan–deposit ratio indicates that a bank has a large proportion of its interest-earning assets in loans and a smaller proportion in other investments. Since loans, especially in Saudi Arabia, cannot be liquidated as readily as some other investments or securities, a high loan–deposit ratio would indicate that a bank would have comparatively low liquidity. Similarly, a low loan–deposit ratio would indicate high liquidity but low utilization and potentially low profitability. The Saudi commercial banks have generally low loan–deposit ratios and thus considerable liquidity. This could be looked on as a favorable situation from the point of view of a bank or monetary authority concerned about the liquidity of specific banks or the banking system. However, since most of the excess domestic liquidity is absorbed through the acquisition of foreign deposits and investments, the result is a potentially strong profit picture while interest rates are high and business investment opportunities are positive.

While the banking system as a whole has experienced erratic loan–deposit ratios (see Table 2.4), on an individual basis the loan–deposit ratios have fluctuated with the major development periods. As can be seen in Table 3.6, from 1973 through 1978 the percentage share of demand deposits gradually

Table 3.16 Commercial banks: loans to deposits ratio (percentage) 1978–1982 (millions SR)

	1978	*1979*	*1980*	*1981*	*1982*
National Commercial Bank*					
Loans	6 677	8 708	12 245	16 144	19 783
Deposits	19 152	24 300	26 967	32 695	45 369
Loan–dep. ratio	35%	36%	45%	49%	44%
Riyad Bank					
Loans	2 470	4 241	5 418	8 389	10 817
Deposits	8 327	11 140	11 011	17 875	19 069
Loan–dep. ratio	30%	38%	49%	47%	57%
Saudi American Bank					
Loans			4 302	4 042	5 178
Deposits			6 277	6 431	9 526
Loan–dep. ratio			69%	63%	54%
Saudi French Bank					
Loans	1 215	1 587	3 897	5 365	7 716
Deposits	1 650	2 146	4 790	5 102	7 312
Loan–dep. ratio	74%	74%	81%	105%	106%
Saudi Dutch Bank					
Loans	790	1 427	1 929	2 149	2 868
Deposits	1 869	2 369	2 965	4 557	5 769
Loan–dep. ratio	42%	60%	65%	47%	50%
Saudi British Bank					
Loans	624	1 273	1 762	2 177	2 514
Deposits	1 501	2 264	3 793	4 366	5 113
Loan–dep. ratio	42%	56%	46%	50%	49%
Arab National Bank					
Loans			1 455	1 570	2 042
Deposits			2 871	3 593	5 233
Loan–dep. ratio			51%	44%	39%
Bank Al-Jazira					
Loans	388	872	1 107	1 284	1 700
Deposits	1 310	1 673	2 003	2 951	4 000
Loan–dep. ratio	30%	52%	55%	44%	43%
Saudi Cairo Bank					
Loans		1 158	2 850	3 058	
Deposits		2 385	4 234	5 680	
Loan–dep. ratio		49%	67%	54%	

Sources: Bank annual reports.
* Data as of end of hijra calendar year.

increased as the financial system geared up to utilize the vast inflow of oil revenues. Between 1977 and 1979 it again fell as real oil prices failed to keep up with imported inflation. However, after the 1979 oil price increases, percentage share declined, falling to below the 1973 figure as rising internal interest rates picked up the difference and as oil demand and prices fell. This indicator base provides a picture of a banking system responsive mainly to fluctuations in the primary revenue source.

Despite the fact that SAMA has a relatively low loan–deposits ratio restriction of 65 percent, the banks have been unable to maintain loans at the 65 percent level. Table 3.16 indicates that the loans to deposits ratios of individual banks have experienced considerable fluctuation, with only the Saudi French Bank showing steady year-to-year growth. Among the possible reasons for the general decline may be the traditional Middle Eastern conservatism which attempts to avoid virtually any risk and the 1982 Ministry of Justice ruling which specifically prevented banks from using mortgages on borrowers' property as security.

Foreign Assets to Deposits Ratio

The increase of net foreign assets in the Saudi banking system may be related to the amount of time and interest-bearing deposits held by the banks, which may have caused them to seek the higher returns available through foreign deposits and investments. Table 3.17 indicates that net foreign assets at the National Commercial Bank and Riyad Bank have continued to increase, but the rate of growth is most significant at several of the Saudized banks with high profit and deposit growth rates. One of the major contributing factors to this growth may be, in addition to the demand for higher returns on local time deposits, the reduction in the legal position of the banks following late payment or non-payment of mortgage or other loans where the payment of interest could be inferred. The ratio of net foreign assets has continued to increase at all the Saudi and Saudized banks, with one notable exception, the Saudi French Bank. Due to the nature of its foreign trade banking activities, the Saudi French Bank maintains larger foreign bank deposit liabilities than foreign bank assets. Among the other banks, the growth trend now is clear, with a growing proportion of deposits leaving Saudi Arabia in the form of foreign assets.

Profitability Analysis

Profitability is generally considered the best measure of a bank management's long-term management ability. The commercial banks in Saudi Arabia have recorded substantial increases in assets, deposits, and profits since Saudization. Detailed analysis of balance sheet and income statement data, however, indicates that while the Saudi banking market still provides a very profitable environment, as financial awareness heightens and competition develops, the kingdom is becoming an expensive source of funds which requires aggressive

Table 3.17 Commercial banks: net foreign assets to deposits ratio, 1978–1982 (millions SR)

	1978	*1979*	*1980*	*1981*	*1982*
National Commercial Bank*					
Net foreign assets			6 959	10 270	14 925
Deposits	19 152	24 300	26 967	32 695	45 369
For. assets–dep. ratio			26	31	33
Riyad Bank					
Net foreign assets			4 876	11 720	9 973
Deposits	8 327	11 140	11 011	17 875	19 069
For. assets–dep. ratio			44	66	52
Saudi American Bank					
Net foreign assets			1 150	2 002	10 549
Deposits			6 277	6 431	9 526
For. assets–dep. ratio			18	31	111
Saudi French Bank					
Net foreign assets			805	−34	−382
Deposits	1 650	2 146	4 790	5 102	7 312
For. assets–dep. ratio			17	−1	−5
Saudi Dutch Bank					
Net foreign assets	315	564	894	2 089	2 505
Deposits	1 869	2 369	2 965	4 557	5 769
For. assets–dep. ratio	17	24	30	46	43
Saudi British Bank					
Net foreign assets			1 504	1 969	2 723
Deposits	1 501	2 264	3 793	4 366	5 113
For. assets–dep. ratio			40	45	53
Arab National Bank					
Net foreign assets			1 028	1 356	5 881
Deposits		3 241	2 871	3 593	5 233
For. assets–dep. ratio			36	38	112
Bank Al-Jazira					
Net. foreign assets			449	1 357	2 200
Deposits	1 310	1 673	2 003	2 951	4 000
For. assets–dep. ratio			22	46	55
Saudi Cairo Bank					
Net foreign assets			545	2 252	
Deposits		2 385	4 234	5 680	
For. assets–dep. ratio			13	40	

Sources: Bank annual reports.
* Data as of end of hijra calendar year.

competition for profitable investment opportunities and loans. Thus, while the major financial indicators have improved and the number of branches has increased, competition also has emerged in response to the overall rate of growth in the economy as the banking system moves towards more moderate long-term growth.

Profits for the Saudi and Saudized banks cannot be aggregated accurately for the entire study period since SAMA does not report bank profits, and most bank results were consolidated with the foreign partners prior to Saudization. However, by studying individual bank results for the period, it is apparent that while growth has been substantial for the banks operating in the relatively non-competitive banking system, Saudization has inflicted a severe price on the 100 percent Saudi-owned banks. The rate of profit growth for these banks has slowed to the point where the National Commercial Bank had only a 1 percent growth rate in 1982 and Riyad Bank slowed to a 1.4 percent growth rate. (See Table 3.18.) Also, even the Saudi Dutch Bank and the Arab National Bank are encountering difficulties as their particular growth patterns, management styles, and credit analysis techniques may not be up to the changing pace.

The profitability of the Saudized commercial banks is also due in part to the special tax benefits which they are given. A 1979 royal decree provided that Saudi foreign bank partners have no corporate income or other tax obligation other than the Zakat (2.5 percent of net worth) until 5 years after Saudization. Maximum income taxes could reach 45 percent on profits exceeding SR 1 million. Tax considerations thus are of concern currently since the foreign shareowners in the Saudized banks are beginning to pay an income tax on a portion of their profits according to the foreign-owned percentage of the equity capital.

Return on Assets

The return on assets ratio provides one of the major and most basic profitability ratios because it indicates the ability of the bank to use its overall asset base effectively and profitably. For example, a decline in the return on assets may indicate that a bank's ability to attract profitable business is diminishing. Thus, despite the fact that a bank shows growth in assets and profits, it may be employing the assets in potential low-growth investments or assets which will have an impact on the long-term profitability of the bank. This may be an especially important factor in Saudi Arabia where the construction and maintenance of branch banks in the underbanked rural areas of the kingdom have thus far been costly and unprofitable.

In the analysis of profitability on assets, the 100 percent Saudi banks have steadily lost ground as bank competition has increased. The National Commercial Bank, with an asset growth of 144 percent between 1978 and 1982, increased profits only 92 percent for the same period. As a result, NCB's return on assets rose to a high of 2.11 percent in 1979 and has steadily declined

Table 3.18 Commercial banks: return on assets, 1973–1982 (millions SR)

	1978	*1979*	*1980*	*1981*	*1982*
National Commercial Bank*					
Profits	301	554	478	571	577
Total assets	20 995	26 301	31 054	41 564	51 137
Rtn. on assets	1.43%	2.11%	1.54%	1.37%	1.13%
Riyad Bank					
Profits	220	312	433	512	586
Total assets	7 915	10 467	14 069	24 178	26 605
Rtn. on assets	2.78%	2.98%	3.08%	2.12%	2.20%
Saudi American Bank					
Profits			109	280	353
Total assets			7 039	7 581	10 906
Rtn. on assets			1.55%	3.69%	3.24%
Saudi French Bank					
Profits		43	66	184	278
Total assets	2 188	3 271	5 686	6 282	8 725
Rtn. on assets		1.31%	1.16%	2.93%	3.19%
Saudi Dutch Bank					
Profits	36	48	76	121	137
Total assets	2 079	2 797	3 566	5 478	7 018
Rtn. on assets	1.73%	1.72%	2.13%	2.21%	1.95%
Saudi British Bank					
Profits	16	33	76	115	147
Total assets	1 999	2 869	4 347	5 102	6 187
Rtn. on assets	0.80%	1.15%	1.75%	2.25%	2.38%
Arab National Bank					
Profits			148	217	256
Total assets			3 281	4 118	6 198
Rtn. on assets			4.51%	5.27%	4.13%
Bank Al-Jazira					
Profits	10	30	46	75	110
Total assets	1 515	1 844	2 297	3 184	4 400
Rtn. on assets	0.66%	1.63%	2.00%	2.36%	2.50%
Saudi Cairo Bank					
Profits			118	121	
Total assets			5 592	8 329	
Rtn. on assets			2.11%	1.45%	

Sources: Bank annual reports.
* Data as of end of hijra calendar year.

to 1.13 percent in 1982 in the face of increased 'Saudized' competition. For comparison, during the same period the Saudi British Bank, with a much smaller asset, capital, and deposit base, increased its return on assets from 0.80 percent to 2.38 percent. This compares favorably with the top ten banks in the world, in assets, which had returns on assets in 1980 ranging from 0.33 percent to 1.56 percent.

Further analysis of the return on assets ratios shows that the more aggressive banks are achieving higher ratios while some of the more established banks, which have found lower risks and higher profits in short-term trade loans, now may be encountering problems. For example, despite increased emphasis on corporate lending activities, NCB has not been able to adjust its overall credit policy sufficiently to maintain the growth pace of some of its Saudized competitors. The inability to utilize its deposited funds base effectively on local loans has led to an increase in foreign asset acquisition. Riyad Bank, which has had some success at maintaining its return on assets rate as a result of the low-cost government deposits, has also relied on foreign asset deposits, as evidenced by a decrease in the loan–deposit ratio. Thus, it qualifies as a relatively passive observer in the Saudi banking system. Of the Saudized banks, the most successful in terms of return on assets have been the Saudi American Bank, the Saudi French Bank, and the Arab National Bank. The Saudi American Bank has been highly profitable due to its efficient use of computerization, market segmentation techniques, well planned branches, and careful maintenance of other assets. The Saudi French Bank, on the other hand, has aggressively loaned and been innovative in the application of balance sheet (medium-term) loan practices. The Arab National Bank, known to be more of a trade-loan oriented commercial bank, still has a strong return on assets ratio since consumer and import trade and imports of bulk construction materials currently remain a strong market. While demonstrating reasonably strong returns on assets in 1980 and 1981, Bank Al-Jazira and the Saudi Cairo Bank have relatively fewer opportunities to develop their asset utilization in a diminished economy since most of their outside investments are in developing areas and their loan/deposit utilization rates in Saudi Arabia are among the lowest of the commercial banks.

Return on Equity

The return on equity ratio provides an important adjunct to the return on assets ratio as an analytical tool. This ratio provides an indication of the degree to which the management of the bank is emphasizing the returns to the current shareholders as opposed to investing assets in current low-return assets with a plan to build for future returns. There is, of course, an implicit question here as to the degree to which the bank management believes that the future for it and the economy is both positive and potentially profitable. When this ratio is combined with the capital ratio, which yields the reciprocal of the leverage multiple, the combination can be used to assess the strength of the bank's

capital position. A rising leverage multiple, for example, indicates a weakening capital position, which is not evident in most profitability measures. For example, Table 3.19 shows that the National Commercial Bank return on equity rose to 47 percent in 1979 and then declined to 24 percent in 1982. These are impressive returns, but against returns on equity of 39.9 percent and 38.8 percent, respectively, for the Saudi American Bank and the Arab National Bank, NCB and Riyad Bank clearly are falling behind.

As with the return on assets ratio situation, the return on equity ratio indicates the relative degree of utilization of bank equity. Here also, as indicated in Table 3.19, the ratio for the Saudi banks has slipped as bank Saudization has taken hold. NCB and Riyad Bank clearly are providing their shareholders with increasingly lower returns per unit of investment. And, in a relatively tighter economic environment, the Saudized banks, with increased shareholder orientation and emphasis on profits, are increasing their equity base through undistributed reserves, a fact which should give shareholders a good feeling. However, Saudi bank officials, with their exposed asset and credit situations, should look on this with envy. Saudi government officials, on the other hand, should look at the low returns on their deposits with NCB and Riyad Bank with some consternation, knowing that as the economy tightens, due to lower oil economy growth, they are possibly losing gains which are needed to carry on the diversification efforts.

Net Profit to Revenue Ratio

In addition to the ratio analyses on assets, equity, and deposits, profits as a percentage of revenues is an indication of the efficiency of the bank's operations. This information is also part of the profitability analysis and relevant in the decisions made by investors, depositors, and borrowers concerning the viability of the bank and the banking system. The net profit to revenue ratio provides a useful gross indicator of the efficiency of the bank operations in terms of holding or reducing cost increases in line with revenue growth. It uncovers gross accounting inconsistencies to focus on costs, forcing banks to tighten operations and to place more emphasis on campaigns to reduce certain key costs.

In Saudi Arabia the profit-oriented management techniques of the Saudized banks of Western origin has proved effective in translating more revenues into profits. By a combination of aggressively holding salary and branch development and operating expenses in line with the growth of new deposits and investments, the Saudized banks have performed somewhat better in this category than the 100 percent Saudi and other Arab origin banks, which have been hit by relatively larger increases in salaries and interest expenses. Possibly the best examples of this situation are found in the Saudi American Bank and the Arab National Bank. At the Saudi American Bank computerization has been a key factor in holding costs while raising revenues. The Arab National Bank, on the other hand, has held costs through the maintenance of relatively

Table 3.19 Commercial banks: return on equity, 1978–1982 (millions SR)

	1978	*1979*	*1980*	*1981*	*1982*
National Commercial Bank*					
Profits	301	554	478	571	577
Equity	698	1 178	1 578	2 000	2 400
Rtn. on equity	43.12%	47.03%	30.29%	28.55%	24.04%
Riyad Bank					
Profits	220	312	433	512	586
Equity	637	937	1 357	1 840	2 389
Rtn. on equity	34.54%	33.30%	31.91%	27.83%	24.53%
Saudi American Bank					
Profits			109	280	353
Equity			385	599	884
Rtn. on equity			28.31%	46.74%	39.93%
Saudi French Bank					
Profits		43	66	184	278
Equity	123	259	276	403	600
Rtn. on equity		16.60%	23.91%	45.66%	46.33%
Saudi Dutch Bank					
Profits	36	48	76	121	137
Equity	139	266	293	369	439
Rtn. on equity	25.90%	18.05%	25.94%	32.79%	31.21%
Saudi British Bank					
Profits	16	33	76	115	147
Equity	110	189	370	432	510
Rtn. on equity	14.55%	17.46%	20.54%	26.62%	28.82%
Arab National Bank					
Profits			148	217	256
Equity			270	450	660
Rtn. on equity			54.81%	48.22%	38.79%
Bank Al-Jazira					
Profits	10	30	46	75	
Equity	56	77	157	219	
Rtn. on equity	17.86%	38.96%	29.30%	34.25%	
Saudi Cairo Bank					
Profits			118	121	
Equity			236	321	
Rtn. on equity			50.00%	37.69%	

Sources: Bank annual reports.
* Data as of end of hijra calendar year.

low-cost facilities, dropping only slightly as they have begun to develop new branches faster than the pace of revenue increases. Recently, however, all of the Saudi and Saudized commercial banks have begun to improve their business controls, largely through more efficient computerization to effect higher productivity. This, along with the general decrease in interest rates, should be the source of future improvements to the net profit to revenue ratio.

In conclusion, the relative management and growth philosophies of the individual banks in the kingdom indicate a critical aspect of bank profitability analysis. While the assets of the 100 percent Saudi banks (National Commercial Bank and Riyad Bank) have continued to grow, their capital and profit ratios have suffered as a consequence of the competition. The National Commercial Bank and Riyad Bank have the natural advantage as Saudi banks to obtain and utilize substantial low-cost government deposits and to receive priority in obtaining other commercial and personal deposit accounts and banking service business. Bank statistics show clearly that the balance sheet growth for the National Commercial Bank and Riyad Bank has been well above the average. This could be considered a natural development since these two banks in 1978 controlled 80 percent of commercial bank assets, 79 percent of the equity, 75 percent of the loans, and 81 percent of the deposits. However, between 1979 and 1981 these percentages dropped to 62 percent, 58 percent, 56 percent, and 55 percent, respectively, an indication of the degree of competition introduced by bank Saudization and the fact that Saudi and business accounts have begun to shift towards other investment alternatives, primarily outside the kingdom.

CONSEQUENCES OF SAUDIZATION

Despite banking growth achieved through Saudization over the last few years, some of the major commercial bank goals have still not been reached. For example, despite the speed with which some of the commercial banks have opened new branches, the number of Saudis employed successfully in both the new and the original branches has not increased measurably. Ironically, bank Saudization and the resulting branch expansion thus far have led to an increase rather than a decrease in the number of expatriates in the banking sector. A number of observers have argued that bank Saudization and the resultant branch network should stimulate keen competition between banks and hence effect the creation of new management positions for Saudi bankers. While competition is beginning to develop, and the banks are adding a limited number of Saudi employees, the employment increases will not be noticed for some time due to the long training time required.[12]

Another problem area is that even though Saudization offers considerable potential, the Saudi government recognizes that the Offshore Banking Units in Bahrain must continue to conduct much of the most important Saudi banking business.[13] SAMA's tardiness in allowing the banks to increase further their

Table 3.20 Commercial banks: net profit to revenue ratios, 1973–1982 (millions SR)

	1978	*1979*	*1980*	*1981*	*1982*
National Commercial Bank*					
Profits	301	554	478	571	577
Revenues	672	1 178	2 072	3 333	4 298
Rtn. on revenue	44.79%	47.03%	23.07%	17.13%	13.42%
Riyad Bank					
Profits	220	312	433	512	586
Revenues	354	503	938	1 777	2 785
Rtn. on revenue	62.15%	62.03%	46.16%	28.81%	21.04%
Saudi American Bank					
Profits			109	280	353
Revenues			366	1 165	1 192
Rtn. on revenue			29.78%	24.03%	29.61%
Saudi French Bank					
Profits			66	184	278
Revenues			429	856	1 076
Rtn. on revenue			15.38%	21.50%	25.84%
Saudi Dutch Bank					
Profits	36	48	76	121	137
Revenues	121	162	304	634	728
Rtn. on revenue	29.75%	29.63%	25.00%	19.09%	18.82%
Saudi British Bank					
Profits	16	33	76	115	147
Revenues	41	132	337	669	677
Rtn. on revenue	39.22%	25.06%	22.55%	17.18%	21.70%
Arab National Bank					
Profits			148	217	256
Revenues			253	400	583
Rtn. on revenue			58.45%	54.21%	43.93%
Bank Al-Jazira					
Profits			46	75	
Revenues			155	319	
Rtn. on revenue			29.64%	23.49%	
Saudi Cairo Bank					
Profits			118	121	
Revenues			336	698	
Rtn. on revenue			32.54%	17.33%	

Sources: Bank annual reports.
* Data as of end of hijra calendar year.

capital base is seen as an irrevocable restraint on the expansion of both the Saudi and Saudized banks and an indication of the importance of the OBUs. The OBUs in effect have no loan constraints because if necessary they can call on the parent bank's capital to back a transaction. Consequently, Bahrain bankers believe that it will be a long time before the Saudi banking system can meet the competition and become a positive force in the development of the financial system.

The restrictions on capital formation in the commercial banks provide an obstacle to the creation of the capital base required to fund construction finance and provide the term loans required to achieve industrial diversification. In response to this situation, and to build a meaningful base for the future, local bankers are obliged to assume a service role in addition to their role as financial intermediaries. This is becoming more obvious as the Saudi banks attempt to perform more than a mere advisory role for the foreign banks which have joined them in syndicating most risk and term loan situations offshore.[14]

As the contracting industry in the kingdom becomes more sophisticated, due to shifts in five-year development plan emphasis and the evolution of new enterprises with complex financial requirements, the role of the Saudized banks will become more critical to the success of the Saudi economy. The banks must become more efficient in their services, and must anticipate critical economic changes and possess the ability to react to those changes. The commercial banks, however, can achieve only a marginal portion of their growth potential due to the capital growth restrictions, and consequently will grow only as rapidly as they are able to increase reserves as a result of profits achieved through efficient operation. If the banks are not able to expand their capital bases at a rate at least as fast as the growth of the economy, they will become increasingly less relevant in the financial intermediation process. Since a major portion of the needs of the contracting community are being satisfied by offshore banks, the trend is clear and uninspiring. It may even be necessary for the government to become more directly involved in bolstering banking activity, and creating a capital market, and there are some indications that this could occur in the near future.[15]

Prior to Saudization a foreign bank operating in the kingdom effectively had the capital of the parent bank to support its loans. After Saudization this extra source of capital was removed, decreasing the bank's ability to lend despite the formal increase in capital enabled through Saudization. The loss of the parent bank capital, however, has not been critical because the Saudized banks still maintain close relationships with the parent organizations through long-term renewable management contracts. In practice, the Saudized banks are still providing the service to guarantee local loans through the overseas parent, thus making loans available to local companies and generating fees to themselves without any commitment of capital. Viewing the Saudization process from this perspective, it appears that the Saudi capital base is being expanded and that the available capital of the entire financial system may effectively be larger than shown in the SAMA and bank statements.[16] This is, however, a misleading

conclusion because, while bank Saudization virtually is complete, the broader financial intermediation process is far from being 'Saudized'.

While competition is slowly developing, and the new Saudized banks are now in an excellent position to continue to expand their capital bases, there are problems. Expansion of the capital bases of the commercial banks will enable the Saudi banks to increase loans in general and loans to a single individual in particular. At present, however, the SAMA requirements for the percentage of bank capital and reserves that may be loaned to a single individual have forced borrowers with large requirements to deal with the OBUs in Bahrain. This causes significant leakage from the Saudi economy, increasing the already substantial share of Saudi deposit and lending activity which is conducted offshore. Regardless, Saudization has enabled SAMA and the commercial banks partially to respond to the challenge from Bahrain through the expansion of loan potential and the creation of corporate finance and merchant banking divisions both inside the kingdom and offshore.

Taking a longer view of the situation, the emergence of a branch network should encourage new depositors and effect a potentially lower cost of funds for the commercial banks in the future. Branch banking is spreading bank services to a larger clientele, especially previously unserved market segments such as small businessmen in remote areas, and women. But Saudi Arabia is still very much a cash society, with heavy reliance on the money exchangers, and this tradition will continue until both consumers and merchants begin to accept banks and bank checks as a normal way of conducting financial transactions.

Considered from another perspective, a major difference in philosophy between the Saudi and Saudized banks early in the Saudization effort was in the bank planning and service activities. While the Saudi banks have been content to loan a relatively small percentage of their deposits, some of the Saudized banks have aggressively expanded their loan bases to gain market share and eventual profits. This approach, combined with an increase in the cost of deposits, has gradually changed the attitude towards future growth and is reflected in the expansion of bank services, geographically and qualitatively.

The newly Saudized banks are now expanding their branch systems and credit-granting facilities in conjunction with the increase in the authorized capital base. This in turn encourages the existing 100 percent Saudi-owned banks, the National Commercial Bank and the Riyad Bank, to expand their branch and credit operations. Thus, despite the inherent advantages that the 100 percent Saudi banks have over the other banks, due largely to the lower cost of funds base they operate with, it is expected that the entire system will benefit from Saudization. Since the Saudized banks have been, during the first few years after Saudization, more active lenders and marketers than the Saudi banks, it is likely that eventually the competition will effect more innovative loan and credit policies in the banking system.

Branch bank development has often been cited as a major benefit of bank Saudization. The new Saudized banks can no longer remain only in the larger

cities but have been encouraged and granted permission by SAMA to open new branches in the less populated towns and villages. This presents a major advantage for the Saudized banks as they can now compete with the National Commercial Bank and Riyad Bank to attract cheaper deposits from the rural areas. Many bank customers in these areas are willing to deposit their savings and receive interest. Thus, while the new banks have an opportunity to expand their deposit bases, most observers believe that the new branches will not yield profits during the next few years. High fixed costs have been incurred in opening the new branches, and keen competition will develop between the banks, limiting profits to much lower levels than experienced during the past few years, a small price to pay for effective monetization of the economy.

The regional distribution of banking activity has not shifted substantially during the last few years, as shown in Table 3.21. The Western and Southern Provinces consistently have absorbed the largest percentage share of banking activity in all categories except deposits. However, closer analysis of the regional distribution of bank deposits, loans, and bank clearings indicates

Table 3.21 Aggregate commercial banks: regional distribution of branches, deposits, loans and clearings, and percentage share (1978–1982) (number of branches and million SR)

	1978		*1979*		*1980*		*1982*	
Province	*Amount*	*%*	*Amount*	*%*	*Amount*	*%*	*Amount*	*%*
Western/south.								
Branches	49	35	67	36	104	40	142	40
Deposits	16 568	41	18 978	40	24 279	36	38 155	42
Loans	10 635	50	14 867	49	19 148	47	22 291	45
Clearings	225 774	78	465 273	84	740 807	84	972 616	84
North./central								
Branches	49	35	65	35	86	33	120	34
Deposits	17 123	42	18 276	38	27 408	40	38 123	42
Loans	7 251	34	10 215	34	14 418	35	18 000	37
Clearings	29 335	10	49 659	9	82 317	9	117 502	10
Eastern								
Branches	42	30	56	30	69	27	90	26
Deposits	6 857	17	10 451	22	16 611	24	13 675	15
Loans	3 299	16	5 338	18	7 469	18	8 747	18
Clearings	32 573	11	42 221	8	59 098	7	72 515	6
Totals								
Branches	140	100	188	100	259	100	352	100
Deposits	40 548	100	47 705	100	68 298	100	89 953	100
Loans	21 185	100	30 420	100	41 035	100	49 038	100
Clearings	287 682	100	557 153	100	882 222	100	1162 633	100

Sources: *SAMA Annual Report, 1401* (1981), pp. 36–37; *SAMA Statistical Summary, 1402* (1982), pp. 59–62.

that while the absolute levels of deposits, loans and clearings increased between 1978 and 1980 in all three regions, by 1982 the Western/Southern and Eastern Provinces declined or only held their ground while the Northern/Central Provinces increased their share of most categories. The Western/Southern Provinces achieved a substantial increase in deposits between 1980 and 1982, but the Eastern Province lost deposits. The reasons for these variable results, especially for deposits, are tied to the fact that the Western and Southern Provinces contain the majority share of the Kingdom's population and the traditional trading centers. On the other hand, development in the oil sector of the economy early in the period under study resulted in relative net gains in both the deposit and loan categories for the Eastern Province. An upsurge in government construction activity in the Central region effected a marginal increase in regional loan activity and mixed results in deposits. Meanwhile the Western and Southern Provinces experienced a gain in percentage share of bank branches between 1978 and 1981.

While the general direction of the economic diversification effort has been positive, the larger population and greater business diversity and sophistication

Table 3.22 Aggregate commercial banks: regional distribution of branches, deposits, loans and clearings, and percentage of growth (1978–1982) (number of branches and million SR)

	1978		*1979*		*1980*		*1982*	
Province	*Amount*	*%*	*Amount*	*%*	*Amount*	*%*	*Amount*	*%*
Western/south.								
Branches	49		67	37	104	55	142	37
Deposits	16 568		18 978	15	24 279	28	38 155	57
Loans	10 635		14 867	40	19 148	29	22 291	16
Clearings	225 774		465 273	106	740 807	59	972 616	31
North./central								
Branches	49		65	33	86	32	120	40
Deposits	17 123		18 276	7	27 408	50	38 123	39
Loans	7 251		10 215	41	14 418	41	18 000	25
Clearings	29 335		49 659	69	82 317	66	117 502	43
Eastern								
Branches	42		56	33	69	23	90	30
Deposits	6 857		10 451	52	16 611	59	13 675	−18
Loans	3 299		5 338	62	7 469	40	8 747	17
Clearings	32 573		42 221	30	59 098	40	72 515	23
Totals								
Branches	140		188	34	259	38	352	36
Deposits	40 548		47 705	18	68 298	43	89 953	32
Loans	21 185		30 420	44	41 035	35	49 038	20
Clearings	287 682		557 153	94	882 222	58	1162 633	32

Sources: *SAMA Annual Report, 1401* (1981), pp. 36–37; *SAMA Statistical Summary, 1402* (1982), pp. 59–62.

of the Western and Southern Provinces is evident in year-to-year regional banking growth. Specifically, during the main oil sector development period between 1975 and 1980, deposit and loan growth was substantial in the Eastern and Northern/Central Provinces. But, when the slowdown in oil activity began during 1982, the Eastern and Northern/Central Provinces experienced a decline in the growth of branches, deposits, loans and clearings, with an absolute decline in Eastern Province deposits. The positive significance of the more steady growth in the regions with the largest populations and most mature business and banking climates provides bankers with a clear indication for their direction of emphasis. It also provides an indication of and basis for some of the areas requiring considerable future regional economic planning.

BANK COMPETITION

The problems the banks have had in responding to the banking regulations and achieving profitable branch banking activities in the face of growing internal and external competition may indicate to some observers that the government is not concerned about the slowdown in the rate of increase in bank activity. There remains considerable concern about possible overbanking and how to handle the critical interest issue. Still, the banks have been given sufficient latitude to upgrade the level of banking activity in the kingdom, effectively monetize the economy, and enhance money market development. Awareness of the opportunities has resulted in a conscious effort on the part of the banks to provide innovative banking services in order to achieve broader monetization without bringing the interest problem to the surface. Expanded and enhanced services within the kingdom's commercial banking system have led to the gradual identification of new market segments, the provision of services targeted at those segments, and efforts to create greater awareness of bank services, thereby enhancing the image of banking generally.

Development and implementation of upgraded banking services in Saudi Arabia have become an important matter that has begun to follow, in theory, some of the marketing techniques which have emerged in the West during the last decade.[17] These techniques are essential if the banks are to maintain and improve their profile and identify and enter new markets. Effective market research, however, is almost non-existent, due to the lack of adequate data on the economy and the people. The resulting broad definitions of ethnic and economic market segments in the current market analyses have limited not only the extent of the marketing effort but also the recognition of important changes in socio-economic conditions in the economy.

Bank service expansion has not in the past been significant, primarily because Saudi banks have experienced high profit ratios, in terms of net return on assets, compared with American and European banks. The prime element in the high profit ratios, as noted before, is the low cost of money (deposits). Consequently, the Saudi banking community, like most businesses in Saudi Arabia, has not seen the need to engage in service innovation. Syndicated

lending was one of the early methods banks were able to utilize to respond to the increasing loan demand, to increase the awareness of bank activities, and to make more efficient use of funds. Even there, however, foreign banks normally assumed the largest share of the financial and administrative burden of the syndicates while the Saudi commercial banks stuck to their profitable local business and relied on their OBU affiliates to handle most of the non-retail business.

As a result of OBU aggressiveness, relatively favorable economic conditions in the 1976–1981 period, low-cost deposits for the 100 percent Saudi-owned banks, and the inability of the banks to increase their capital bases prior to bank Saudization, most of the foreign joint venture banks fell behind in business development. Competition in other Gulf countries has, however, effected the beginnings of a willingness to market bank services through more aggressive marketing research and advertising. This spirit has spread to Saudi Arabia and other Arab countries, and the situation is improving, with the exception of Syria, Iraq, Libya, Egypt, and Algeria where the monopoly banks have not been forced by emerging competition to demonstrate creative approaches in offering banking services.

Clearly, while there are plans to monetize fully the private sector banking surplus in Saudi Arabia, the commercial banks are far behind in the application of consumer-oriented marketing techniques. There is, however, an awareness of the intricacies of the three main markets which are driving further development of the banking system: (1) the domestic retail market, (2) the corporate sector market, and (3) the international market. Within each of these main markets there are various secondary market segments which can be served. Specifically, in the domestic retail market most recent bank interest has been in achieving increases in demand and savings deposits and some interest has been in providing investment and property management services, but clearly there is a lack of interest, for various reasons, in developing the normal consumer loan and account services found in the West. Corporate sector banking activity includes financing and financial management operations for local and overseas contractors and trading organizations doing business in Saudi Arabia, but there has not been a serious attempt to identify business opportunities related to the expanding secondary and service industries in Saudi Arabia. The international market encompasses public and some private sector international bond issues and loan syndications, which may include downstream petroleum investments, but generally covers only development as opposed to profit-oriented activities.

Competition is developing in the consumer, corporate, and international markets and their various segments, as witnessed by the fact that in the late 1970s most significant corporate loan business went to loan syndications formed by the largest Western international banks, for good margins and generous front-end fees. Recently, however, the Arab private sector banks, including several in Saudi Arabia, or with a Saudi capital base, have been able to capture some of this business with low equity and considerable home government support, which has translated to easy borrowing terms and high

leverage in terms of assets to capital. The situation has become highly competitive, even within the Arab Middle East, as the multi-government megabanks have put a severe squeeze on the smaller regional banks. Entering the market with capital bases equal to some established Western private banks, the megabanks forced out the smaller banks and have recently begun to eye the domestic corporate as well as the international markets.[19]

Consumer preferences for specific banks have not in the past been determined by individual bank strengths but rather by the national origin of the bank and family tradition, even though each bank offers different strengths, reputations, and basic services. Effective provision of services is beginning to indicate where specific bank capabilities are more important than national origin or family tradition. Yet the use of media is still quite limited in Saudi Arabia, with television advertising not permitted and severe limitations placed on the content of other media advertising, indicating that reputation and contacts still provide much of the basis for choice of a bank.

Also, local banks have begun to drop the international bank marketing approach which provided an omnibus, 'cover-all' image but failed to provide individuality. Advertising was vague and directed at corporate treasurers and other corporate officers at the expense of providing evidence of the bank's qualities and capabilities. Most of this advertising stressed how 'Arab' the bank and its management were compared with other banks. With the emergence of meaningful competition after the completion of Saudization, the Saudi commercial banks are beginning to follow the lead of some of the major Arab Middle Eastern government-backed banks in providing new services and products and specialized advertising, focusing on bank specialties such as dealing in Arab currencies, Arab currency certificates of deposit, and the introduction of bond issues denominated in strong local Arab currencies.

Some banks in the kingdom have assessed their strengths and weaknesses and positioned themselves to capture new segments, using the media and other techniques available to them. Also, direct sales loan operations, in competition with the OBUs, have been established, and the more aggressive banks are engaging in personal direct sales efforts to increase market share. There has also been market segmentation and service expansion within existing markets. The most profitable and aggressive Saudized bank, the Saudi American Bank, is concentrating on services for the previously unbanked small business sector while conducting the kingdom's largest financial support operation for contractors. Since women in Saudi Arabia are not allowed to conduct extended business transactions with men, women's branches have also been constructed and organized, with some success.

The Saudi British Bank, with a very different strategy, is attempting to satisfy the medium-term banking needs of the larger Saudi companies. The Saudi British Bank has also perceived that it can serve a previously ignored segment, new joint venture firms, that the bank can grow with, providing the unique developmental services required by that segment. In a similar approach, Bank Al-Jazira has identified a gap in the provision of day-to-day

banking needs of medium-sized companies and foreign exchange services. For Bank Al-Jazira this is a logical direction to head in since it has low capitalization and consequently must turn its capital relatively quickly.

In contrast to the Saudi British Bank and Bank Al-Jazira, Riyad Bank, which is 38 percent owned by SAMA, controls the Petromin and Saudi national airline (Saudia) pension fund accounts and handles the investment portfolios of more than 20 Saudi companies, leaving international banking activities to the other banks including its own OBU, Gulf Riyad Bank, in Bahrain. While Riyad Bank engages in some wholesale banking activities, in parallel with government efforts to make loans which other Saudi banks might shy away from, the majority of its loans are, like its deposits, short-term, not exceeding 6 months to 1 year, and obtained mainly from the small depositor segment which has in the past been oriented towards depositing only with a 100 percent Saudi-owned bank.

Another contrast in service orientation and the customer segment served relates to a situation which SAMA and the Ministry of Finance and National Economy have encouraged for several years, the development of more effective bank communications and operating facilities. The Saudi American Bank has been one of the leaders in this activity, computerizing much of its operations to reduce costs and draw both corporate and retail clients who require the many benefits of extensive computerization. Other banks also have responded, and by the end of 1982 all of the Saudized banks were scheduled to be linked with central computer operations.

As bank competition has sharpened, the 100 percent Saudi-owned banks have responded to the challenge of the Saudized banks by developing portfolio management services and short-term dollar funds. They have also diversified into other banking activities which were dominated previously by the international banks. For example, NCB and Riyad Bank became active in offering portfolio management to high net worth customers and in establishing their own short-term dollar funds. Thus, the Saudi banks have been pushed into a more service-oriented role as a result of the competition of the Saudized banks.

An equal share of the credit for the growth of banking services should go to the international and merchant banks which have continued to enter the kingdom to take on much of the high-risk term financing business and provide various investment advisory services. It would be premature to conclude that these developments were solely the result of more competition on the part of the Saudized banks. Clearly, there are limits to the increase in competition due to the fact that there is little prospect for additional banks being granted licences to operate in Saudi Arabia. Consequently, bank service improvement and expansion should continue, and it will result as much from the increase in financial sophistication among Saudi citizens, and specific consumer demands for new banking services, as from bank service development.

DISCUSSION QUESTIONS

3.1 What are the major Saudi money market institutions and what government organizations monitor these institutions?
3.2 How is Saudization of the kingdom's financial system being accomplished?
3.3 List the reasons for the need to expand banking services in Saudi Arabia over the last decade, and in the future.
3.4 What were the motives behind the 1976 decision of the Saudi Council of Ministers to effect Saudization of the commercial banks in the kingdom?
3.5 What are the advantages of Saudization of the foreign-owned commercial banks in Saudi Arabia?
3.6 Explain the process by which Saudi control over the banking system has been accomplished.
3.7 What are the prominent causes of the wide percentage fluctuations in the balance sheet aggregate totals of the commercial banks in Saudi Arabia?
3.8 Why should economic sector credit distribution eventually shift in favour of Saudi secondary industry?
3.9 Why have some Saudized foreign banks lagged behind in profitability and in expanding the local loan base?
3.10 What was the reason behind the decline in foreign assets at the Saudi commercial banks during 1978–1979?
3.11 Due to oil revenue expansion in Saudi Arabia, the yearly sources and applications of bank funds have shifted considerably in several categories. Identify these categories and explain the direction of, and the reason for, their shift.
3.12 Identify the major factors affecting Saudi commercial bank growth in assets, deposits, and profits since Saudization.
3.13 What are the major sources of Saudi commercial bank revenues? Briefly explain each major source and identify the risk involved in its related activity.
3.14 The Saudi banks have to adapt to new service strategies and to adjust loan portfolios due to the loss of low-cost funds and stringent reserve requirements. How have the banks maintained their profit ratios under these conditions?
3.15 Explain the implications of the new Saudi tax law on commercial bank profits.
3.16 What are the most significant indicators of the performance of bank management in Saudi Arabia?
3.17 Is there a way to determine which Saudi bank might have potential liquidity problems? Discuss.
3.18 Why are the Saudi banks not able to attain the relatively low loan to deposit ratio restriction set by SAMA?

3.19 What are the implications of increasing the number of bank branches in Saudi Arabia?

3.20 The Saudi commercial banks now are in a better position to continue expansion of their capital base. Are there any problems associated with this expansion? Discuss.

3.21 Discuss the measures taken by the Saudi commercial banks to face competition from within and outside Saudi Arabia.

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CHAPTER 4

Money Market Institutions: II

The offshore banking units (OBUs) in Bahrain, which are the subject of the first section of this chapter, exert significant money and banking market influence on the Saudi money market insitutions. The OBUs are outside SAMA's direct authority, but SAMA is sometimes able to act indirectly on these units through its worldwide money market activities. The OBUs and the associated financial services which have accompanied them provide a vehicle to serve domestic banking needs in Saudi Arabia which cannot be met onshore in the kingdom. Because the OBUs have an impact on the Saudi economy without answering directly to SAMA or any other monetary authority, their role is often misunderstood. Generally, they provide many important services which enable government and private Saudi investors to enter the international money markets.

The development of the Saudi international banks, which have provided another option and outlet for Saudi money market funds, is the subject of the second section of this chapter. The Saudi international banks and banking activities have grown in importance and independence over the last few years. As significant forces in the world syndicated lending process between 1977 and 1982, these organizations have paved the way for another generation of Saudi financial growth.

The last subject area taken up in this chapter is the role of the money exchangers and the representative branch offices of Islamic banking institutions in the Saudi financial system. An often underrated group of loosely knit and competitive family-run organizations, the money exchangers have strong historical and social ties in Saudi Arabia. Faced with direct government controls over their money market activities, the money exchangers gradually will become subject to full banking controls during the coming years. Estimates are that the money exchangers control up to 25 percent of the money market in Saudi Arabia, the international banks not licensed to do business in Saudi Arabia control 50 percent, and the commercial banks possibly only 25 percent, a figure likely to increase with bank Saudization and more controls on the money exchangers. Representative branch offices of Islamic banking institutions present an alternative for future consideration in the Saudi money

market. While not yet a significant factor, these organizations are drawing on Saudi funds and are preparing to assume a role as a non-interest option.

OFFSHORE BANKING UNITS

As the Saudized commercial banks move towards a more competitive banking environment, it is evident that improvements in bank services and increased monetization of the Saudi economy are prerequisites for survival. However, there is another variable in the bank service equation that has exerted a significant influence over the activities and financial results of the banks. This variable, the offshore international banks operating directly and indirectly in Saudi Arabia, has in many ways been the prime motivational banking force in the kingdom since they have been virtually unregulated in meeting various construction and trade finance requirements which have far exceeded the resources of the local banks.

International banks conducting operations in Saudi Arabia are divided basically into two categories: (1) Bahraini OBUs, and (2) Saudi international banks. Development and trade spending in Saudi Arabia has been the major factor in the growth of the OBUs and the Saudi international financial institutions. Accordingly, it is appropriate to evaluate the growth of both the OBUs and the Saudi international banks since they interact and support each other and the Saudi commercial banking system to a significant degree. These organizations carry out similar functions, and their sources of funds and methods of operation differ in varying degrees. However, each institution derives its purpose and role from the main source of liquidity in the region: the flow of Saudi crude oil funds.

Role of the Offshore Banking Units

One of the main purposes of offshore banking centers such as Singapore, the Caribbean, and Hong Kong is to provide a financial center within an economic region to serve not only the countries within it but also other countries. In this manner the OBUs within these centers generate exposure to and banking experience within other economies. A second consideration is that OBUs help to direct funds controlled by the governments and institutions of the countries within the region towards effective local use and control. In this way the OBUs create the means for greater financial security for the countries concerned. The growth of an OBU does not depend necessarily or entirely on the wealth of the local region outside the OBU host country, as with the Caribbean banking institutions which serve primarily the needs of US multinational firms and citizens. However, OBU activity is enhanced if the area is relatively wealthy and possesses excess funds for foreign investment. The critical factor is that the offshore banking center and the market for the services of the OBUs should be established and recognized internationally.

Among the other major benefits the OBUs provide for the region is impetus

for improving important non-financial infrastructure expansion within the host country designed to achieve better communications, especially telephone and telex, improved access to and within the region, including better airports, more flexible immigration rules, and better hotels and other social amenities. As a result, economic development is enhanced, with living standards generally improved and business able to obtain the necessary capital and banking services. Thus, the OBUs are a positive force which can attract foreign investors from many parts of the world. They can help to effect the provision of services for international markets which may set a chain of events into motion that improves the financial market in the host country as well as the economy of the region as a whole.

The concept of OBUs organized to avoid tax liabilities and circumvent central bank rulings on lending and interest rates and payments is not new, but in the Arab world, especially the oil-producing Arabian Gulf states, the role of the OBUs has taken on a new and significant meaning. Kuwait, Qatar, and the United Arab Emirates did not even have their own currencies approximately 20 years ago, yet already these countries, partly as a result of the significant OBU development in Bahrain after 1973, have achieved substantial expansion in their financial market operations that serve as models for other developing countries.

The Bahraini OBUs

Although OBU activity in Bahrain officially began in 1975, the provision of effective central banking powers for the Bahrain Monetary Agency (BMA) in 1973 was the primary development factor. These powers included the supervisory powers required to monitor, supervise, and license banks in Bahrain. The decline of Beirut as the center of Middle East banking, the commencement of the offshore Eurocurrency market, the rise in Gulf economic activity as a result of the increase in oil prices, along with the offshore banking activity already under way as Bahrain's economy matured, provided the BMA with an impetus to follow the example of the Singapore offshore banking market.[1] Among the other reasons for the growth of an OBU market in Bahrain was the fact that the Bahraini financial market had matured, economic growth was moderate, and as the number of banking institutions in Bahrain increased, they naturally began expanding their activities, especially into the offshore market.[2]

Initial OBU activity in Bahrain evolved from the lead established by Citibank and Algemene Bank which were already established in Bahrain but in 1975 obtained OBU licences. By the end of 1976 the 26 OBUs had assets of $6.2 billion. By the end of 1979 the number of OBUs had grown to 65, and they controlled $27.7 billion in assets; by August, 1982, the OBUs peaked at $61.6 billion, declining to $56.1 billion in March, 1983. Most of these assets were derived from Saudi, Kuwaiti, and other local currencies drawn to Bahrain or loans booked elsewhere, especially in Saudi Arabia. This process has continued as the Bahraini OBUs have surpassed local commercial banks in the development of assets and loans. Also, the OBUs have developed considerable business from currency swaps, trade finance, contract bonding and bond sales. Although the basic OBU program centered around established foreign banks including Citibank and Algemene Bank Nederland, the Arab banks, especially Arab consortium banks, quickly became a part of the OBU community.[3]

Recently, Islamic banks, led by Faisal Islamic Bank of Bahrain, have entered this fray. Accordingly, Bahrain has been identified as a syndication center, gathering funds from the region for worldwide loans.

The basic legal requirements and benefits for the Bahraini OBUs arise from the fact that in Bahrain an OBU can carry out all types of business with international clients. However, the OBUs cannot do business with residents of the state of Bahrain. Bahraini residents must use Bahraini registered commercial banks for their financial needs. Further, the OBUs will:

(1) be full branches of parent banks and have specific financial commitments to the parent;
(2) be fully staffed and engaged in licensed operations;
(3) not conduct banking services for local citizens, but they may deal with the government and with projects approved by the BMA;
(4) provide all banking services desired, except for current accounts, for non-residents of Bahrain;
(5) meet no reserve requirements or liquidity ratios;
(6) supply monthly statistical and balance sheet information to the BMA;
(7) submit an income statement to the BMA and publish it within 90 days from the end of the year;
(8) pay an annual licence fee of BD 10 000 but pay no taxes.

Existing fully licensed banks may apply for an OBU licence for non-resident businesses.[4]

The Bahraini OBUs have led Gulf banking in a number of important activities, especially the movement of regional currencies. Despite the fact that this activity is not directly development-oriented, is dominated by regional branches of London currency dealers, and is declining as the central banks in other Gulf countries act to stabilize currency outflows, it still provides a critical service. On the other hand, a major development service and major growth area for the OBUs has been contractor bonding for foreign construction companies operating in the Gulf. In Saudi Arabia, for example, SAMA allows only those contracts with Saudi bank authentication to be placed on the SAMA approved contractor list for bidding on government contracts. The bond value must not exceed 25 percent of the capital and reserves of the issuing bank; thus the role of the Saudi and Saudized banks in this business is severely limited. The OBUs, which do not operate under such restrictions, are able to take much of the contract bond market, and the Saudi bank acts as a finder or an agent and earns a fee without actually funding the arrangement.

While the Bahraini OBUs have been quite successful in a number of key commercial banking categories, they are encountering several problem areas

which will limit their future growth. The problem areas include risk evaluation, expansion of the deposit base, and profitability. The first problem, risk and credit evaluation, is magnified as a result of the wholesale nature of the Bahraini money market in which there is little direct contact between bank and client. As in other banking environments, this lack of contact occasionally may lead to credit overexposure for banks attempting to expand loan activity. At other times some good business may be lost because the sources of information on a critical market segment are unavailable. The result is that prime customers are frequently able to play off one bank against another to get better yields, or a bank they feel compelled to take on customers of less than the best credit standing. A prime example of this occurs in syndicated lending and sovereign risk loans where an outside bank acts as agent for the syndicate. The members of the syndicate, who may be several thousand miles away, place a considerable amount of reliance on the agent bank to keep up with the loan progress. Frequently, the agent banks have neither the interest nor the ability to provide such a service.

The second major development problem for the OBU bankers is obtaining and maintaining a deposit base which has sufficient time maturity to support a development-oriented lending portfolio. Major international banking institutions usually have a broad and indigenous deposit base which provides them with dependable and relatively lower cost investment funds. Offshore banking institutions are rarely able to enjoy this favorable situation, especially those in the Middle East where most financial transactions are short-term and highly liquid. The Bahraini OBUs have been put to the test in this area because the maturities on their deposit liabilities are extremely short by international standards. For example, in early 1982, 17 percent of the deposit liabilities of the Bahrain OBUs were due within 7 days, 43 percent due within 1 month, 76 percent due within 3 months, and 93 percent due within six months.[5] Further, while the percentage share of OBU assets held in Arab countries is rising, most of these assets still are located overseas. At the end of March, 1983, 47 percent of the OBU assets were in Arab countries, 26 percent in West Europe and 8 percent in other offshore banking centers. The percentage share of the assets held in US dollars was 71.7 percent.[5]

The extremely short-term deposit structure of the Bahrain OBUs and the share of assets located outside the Arab world can cause considerable instability in tight financial conditions. Further, the most volatile and short-dated money market for the OBUs is the Saudi Riyal, which also is the largest and most important market. The Saudi Riyal market, which tends to be thin and unpredictable much of the time, can move several points in a few hours. Since the OBUs have no lender of last resort and depend to a large degree on the fact that SAMA utilizes and unofficially supports the OBUs, that support is only grudgingly provided. Consequently, the situation could be quite dangerous if the Saudi riyal market was tightened beyond normal limits.

The profitability of the Bahraini OBUs is the third area of concern. Here the problem is the conservative nature of capital investment in the Gulf area, and

the tendency for major private sector investments to be handled directly through a Western international bank, with the OBUs only a money funnel. For example, in 1981 the total OBU profits were $191 million on average assets for the year of $32.2 billion, a return on assets of 0.59 percent, compared with an international bank guideline parameter of approximately 1 percent. The situation becomes even less favorable when the Arab Banking Corporation (ABC) is removed from the comparative data. The return for the OBUs, excluding ABC, was $146 million on average assets of $31 billion, a return on assets of 0.47 percent.[6]

Despite the challenges of possible credit overextension, short deposit maturities, and low profitability, the greatest challenge and opportunity for the OBUs is to become the main conduit for the Arab financial system. This factor will become increasingly important as the Arabian Gulf and other Arab countries expand their involvement in international finance and other forms of economic diversification. Until recently, much of the debt financing in the Gulf area was placed directly in the major financial centers. Now, however, due largely to the support of the Bahrain-based ABC, Gulf International Bank (GIB), and several other major Saudi and Gulf banks, more of this activity is being placed through Bahrain. While the ABC and the GIB can support their own international financial activity through their international banking connections, the Saudi banks are not yet in this position, due largely to the limited size of the Saudi financial system, the number of commercial banks, and the conservative SAMA financial ratio requirements. Saudization has improved the financing capabilities of the commercial banks, but the role for the Bahrain OBUs remains substantial.

As the Saudi banking system gradually takes on more of the control of local international banking activity, the next generation of Bahraini OBU growth might include merchant banking, more advanced project financing techniques and activity, enhanced investment advisory services, and development of ancillary markets for commodity trading, insurance, corporate finance, consumer credit, leasing, and securities marketing. These options will become increasingly available with the investment of Gulf Arab capital in and through Arab financial institutions.

Saudi Arabia and the Bahraini OBUs

Although the Saudi Arabian Monetary Agency has a charter enabling it to carry out its functions within defined areas, it carries out another very important function not specified within its charter, which is implied by its very close connection with the Ministry of Finance and National Economy. SAMA is indirectly, and often directly, the financial 'broker' for the Ministry of Finance. Thus, although SAMA is not permitted to engage in trade activities, according to Article 6 of the Banking Control Law, and it does not have a capital base, it does manage the financial assets of the government, even though this activity is not specified anywhere in the SAMA charter. For

example, SAMA is directly involved in setting the official exchange rates for the Saudi riyal in terms of the US dollar. Furthermore, SAMA places deposits, albeit on behalf of the Saudi government, with foreign banks, and it buys and sells securities and receives dividends and interest. These activities are conducted frequently through the OBUs in the Bahrain.

One view held by many bankers is that SAMA essentially is using the OBU market in Bahrain to assist the operation of the Saudi money market until such time as SAMA has formulated plans and developed the financial infrastructure for an operational Saudi financial market. This situation indicates clearly that Bahrain has replaced Beirut as a temporary international financial center for Saudi Arabia and other Gulf countries, creating a relationship similar to that which exists between Hong Kong and Communist China.

Despite SAMA's use of and reliance on many Bahraini OBU services, it is no secret to the banking community that SAMA possesses the classical central banker's distrust of external markets, which plays such a large role in the Eurodollar concept. Accordingly, SAMA has acted to prevent the Bahraini OBUs from speculating on the interbank market and effectively internationalizing the riyal. Thus, it is not surprising that SAMA, in March 1980, shocked OBU currency speculators in Bahrain, who were up to $30 million short on riyals, by revaluing the riyal upward.[7] SAMA's March 1980 revaluation, together with the introduction of the $50 million limit on the riyals which a Saudized bank can exchange on any business day, are only two examples of the actions taken by SAMA against attempts at riyal internationalization and to dissuade speculation by Saudi banks.

SAMA has not published any official opinions concerning the OBUs. Although there is a feeling of mistrust towards the OBUs, the creation of the two Saudi OBUs in Bahrain, with SAMA's approval, indicates that the mistrust has not yet been translated into complete displeasure with the system. The establishment of the Gulf Riyad Bank, jointly owned by the Riyad Bank (60 percent) and Crédit Lyonnais (40 percent), as an OBU in Bahrain, provides SAMA with at least a partial representation in the OBU market through its substantial shareholdings in the Riyad Bank.

Decisions made by SAMA have a direct impact on the OBUs, as was made clear in the 1979 SAMA move to denominate government contracts above SR 300 million in US dollars. This had the effect of reducing the need for forward exchange facilities to guarantee overseas companies the value of the riyals they were due to receive in the future, a condition which existed before this decision was made. This decision has been further expanded by the early 1983 SAMA announcement that henceforth the banks would be required to refer any offshore syndicated loans to SAMA for analysis prior to approval.

SAMA not only can place restrictions on the amount of riyal to dollar exchange, but it also has considerable influence over riyal interest rates which can affect the movements in and out of the riyal. SAMA currency revaluations also have an impact on interest rates, significantly influencing OBU business in Saudi Arabia. The March 1980 revaluation of the riyal upward to short-circuit

short trading by some OBUs also indirectly caused a reduction in riyal interest rates from 19½ percent for 1 month deposits to an acceptable normal level of 13½ percent within a few days.[8]

Because of the problems SAMA has had in creating a meaningful Saudi financial market, the agency recognizes the positive contribution the OBUs have made to the development of the Saudi economy. SAMA clearly lacks many of the traditional central bank tools which exist in other countries to control the economy. This situation, paradoxically, means that SAMA is not able to respond to OBU monetary actions on a daily basis, causing the agency to rely on the OBUs to do indirectly what it is in effect unable to do. SAMA's major problem areas are in two categories. First, the lack of a taxation structure and/or government borrowing eliminates two tools which could be used to help control the money supply, interest rates, and general business activity levels. Second, the Islamic disapproval of interest on monetary transactions, together with SAMA's own charter restrictions, would naturally limit the agency's use of such traditional tools even if it sought to develop them.

In order to respond to its monetary policy limitations, and to carry out its objectives of safeguarding the value of the riyal while at the same time maintaining the spirit of free exchange which characterizes the Saudi free enterprise economy, SAMA is obliged to respond indirectly to the actions of the OBUs. An unwritten 'gentleman's agreement' exists between the commercial banks and SAMA according to which the banks seek SAMA's approval when syndicating or granting substantial loans to foreign commercial entities for operations outside Saudi Arabia. Similarly, riyal deposits placed by the Saudi commercial banks in the OBUs are subject to SAMA controls through its power to adjust the legal reserve requirements. SAMA can pursue the matter even further, if it wishes, by adjusting the exchange rates between the riyal and the dollar, thus discouraging or encouraging currency movements between Saudi Arabia and Bahrain.

The Bahraini OBUs essentially have become the money market managers for the Gulf region, attracting not only Saudi riyal deposits but also Kuwaiti dinars and UAE dirhams. The exchange of currencies between the Gulf economies implies that market speculation is not restricted to any one country but rather encompasses the entire Gulf region. Consequently, speculative activity in the riyal can and has developed from demands in Kuwait as well as from local domestic speculators, a factor which SAMA must consider in its response to OBU activities.

SAMA's relationship with the OBUs clearly depends largely on the continued development of the OBU market in Bahrain or other countries in the Gulf region. However, in line with the need to prevent overbanking in the region, the Bahrain Monetary Agency decided in 1982 that fewer OBU licences would be granted, with priority given to banking institutions from Latin America and the Far East. This change indicates that future OBU operations will be more geographically balanced and oriented towards trading and financing in all important parts of the world. A 1982 report published by *Arab*

example, SAMA is directly involved in setting the official exchange rates for the Saudi riyal in terms of the US dollar. Furthermore, SAMA places deposits, albeit on behalf of the Saudi government, with foreign banks, and it buys and sells securities and receives dividends and interest. These activities are conducted frequently through the OBUs in the Bahrain.

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SAMA has not published any official opinions concerning the OBUs. Although there is a feeling of mistrust towards the OBUs, the creation of the two Saudi OBUs in Bahrain, with SAMA's approval, indicates that the mistrust has not yet been translated into complete displeasure with the system. The establishment of the Gulf Riyad Bank, jointly owned by the Riyad Bank (60 percent) and Crédit Lyonnais (40 percent), as an OBU in Bahrain, provides SAMA with at least a partial representation in the OBU market through its substantial shareholdings in the Riyad Bank.

Decisions made by SAMA have a direct impact on the OBUs, as was made clear in the 1979 SAMA move to denominate government contracts above SR 300 million in US dollars. This had the effect of reducing the need for forward exchange facilities to guarantee overseas companies the value of the riyals they were due to receive in the future, a condition which existed before this decision was made. This decision has been further expanded by the early 1983 SAMA announcement that henceforth the banks would be required to refer any offshore syndicated loans to SAMA for analysis prior to approval.

SAMA not only can place restrictions on the amount of riyal to dollar exchange, but it also has considerable influence over riyal interest rates which can affect the movements in and out of the riyal. SAMA currency revaluations also have an impact on interest rates, significantly influencing OBU business in Saudi Arabia. The March 1980 revaluation of the riyal upward to short-circuit

short trading by some OBUs also indirectly caused a reduction in riyal interest rates from 19½ percent for 1 month deposits to an acceptable normal level of 13½ percent within a few days.[8]

Because of the problems SAMA has had in creating a meaningful Saudi financial market, the agency recognizes the positive contribution the OBUs have made to the development of the Saudi economy. SAMA clearly lacks many of the traditional central bank tools which exist in other countries to control the economy. This situation, paradoxically, means that SAMA is not able to respond to OBU monetary actions on a daily basis, causing the agency to rely on the OBUs to do indirectly what it is in effect unable to do. SAMA's major problem areas are in two categories. First, the lack of a taxation structure and/or government borrowing eliminates two tools which could be used to help control the money supply, interest rates, and general business activity levels. Second, the Islamic disapproval of interest on monetary transactions, together with SAMA's own charter restrictions, would naturally limit the agency's use of such traditional tools even if it sought to develop them.

In order to respond to its monetary policy limitations, and to carry out its objectives of safeguarding the value of the riyal while at the same time maintaining the spirit of free exchange which characterizes the Saudi free enterprise economy, SAMA is obliged to respond indirectly to the actions of the OBUs. An unwritten 'gentleman's agreement' exists between the commercial banks and SAMA according to which the banks seek SAMA's approval when syndicating or granting substantial loans to foreign commercial entities for operations outside Saudi Arabia. Similarly, riyal deposits placed by the Saudi commercial banks in the OBUs are subject to SAMA controls through its power to adjust the legal reserve requirements. SAMA can pursue the matter even further, if it wishes, by adjusting the exchange rates between the riyal and the dollar, thus discouraging or encouraging currency movements between Saudi Arabia and Bahrain.

The Bahraini OBUs essentially have become the money market managers for the Gulf region, attracting not only Saudi riyal deposits but also Kuwaiti dinars and UAE dirhams. The exchange of currencies between the Gulf economies implies that market speculation is not restricted to any one country but rather encompasses the entire Gulf region. Consequently, speculative activity in the riyal can and has developed from demands in Kuwait as well as from local domestic speculators, a factor which SAMA must consider in its response to OBU activities.

SAMA's relationship with the OBUs clearly depends largely on the continued development of the OBU market in Bahrain or other countries in the Gulf region. However, in line with the need to prevent overbanking in the region, the Bahrain Monetary Agency decided in 1982 that fewer OBU licences would be granted, with priority given to banking institutions from Latin America and the Far East. This change indicates that future OBU operations will be more geographically balanced and oriented towards trading and financing in all important parts of the world. A 1982 report published by *Arab*

Banking and Finance pointed out, based on the 1982 licence limitations, along with comments by the Saudi Ministry of Finance and National Economy and discussions with the Governor of the Bahrain Monetary Agency, that the objective of the Bahraini OBUs was not only profitability but protection for the existing deposit base.[9] This, however, appears to be in contrast with the earlier efforts of the Bahrain OBUs and OBUs in other areas, where finding a convenient outlet for regional funds flows is the stated primary objective.

Saudi OBUs have become particularly active over the last few years, acting virtually as onshore banks in many ways. One example of this is the Al-Saudi Banque offshore banking unit in Bahrain which has had substantial asset and deposit growth every year since 1978. Much of Al-Saudi Banque's financial activity was in the Eastern Region of Saudi Arabia where local trade financing comprised the majority of its business. While the Bahrain branch of Al-Saudi Banque primarily engages in trade financing, like most other consortium banks in the region, it also provides financial management, exchange operations, and money market support. Al-Saudi Banque, however, recently has engaged in a decreasing amount of Euromarket monetary and capital market activity, directing more resources into trade finance which has a higher profit potential and lower risk potential.

A key question in the continued development of the OBU market in Bahrain is whether banking will remain the primary service offered by Bahrain, with other financial services providing only a supporting role, or if there will be a gradual reversal of these roles. The BMA has made it clear that Bahrain plans to remain the primary center for banking services in the region until indigenous or alternative centers are established. BMA statements also make it obvious that the OBU facility in Bahrain will remain active simply because of the strong connection the OBUs have with the economy of Saudi Arabia, and Bahrain's proximity. However, this connection primarily is based on the role the OBUs perform in providing construction guarantee financing facilities for major Saudi Arabian projects, an activity which has begun to slow with the completion of the Saudi infrastructure.

The government of Bahrain and the OBUs are optimistic because many of the government and oil industry projects in Saudi Arabia are so large that the guarantee requirements far exceed the limits set by SAMA on commercial bank loans to individual borrowers. Many of the offshore riyal transactions in Saudi Arabia are conducted by Western or Far Eastern joint-venture companies attempting to meet a bid bond, contract guarantee, or performance bond in their home country. This and other riyal lending is for short terms, only 3 to 6 months, which are the normal terms for riyal deposits, and frequently it is more convenient to make the loan arrangements through Bahrain rather than conduct the transaction through foreign banks not acceptable to SAMA in the guarantee process. Taking into consideration the huge development plans budgeted for in the kingdom, despite the 1982–1983 downturn in oil prices, it is likely that future Bahrain OBU growth and cooperation with the Saudi economy are based on solid ground.

Another positive consideration for the future of the OBUs is that, even though it is possible to obtain 1 year riyal loans in Saudi Arabia, these normally are revolving credit arrangements as opposed to specific loan terms. Long-term loans are, however, available selectively from Bahraini OBUs, and occasional syndicated credits are available. It is clear that the availability of riyals in Bahrain is a reflection of the liquidity in Saudi Arabia, a fact which becomes painfully evident at hajj time and just before the Saudi government budget is published. Most government payments are slowed during this period, in anticipation of the new budget.

The conclusion is that the only factor which could deter growth in the OBU market is the lack of additional bank management capability, especially local management talent. Developing local bank expertise is of great concern because the number of foreign bankers employed in the decision-making positions has been increasing, in even the fully Arab banks, and the number of Bahrainis entering banking has not been meeting the need.

One possible solution to the bank management problem is a monetary union which would harmonize monetary and economic planning in the Gulf. There has been discussion of a monetary union in the Gulf for a number of years. In fact, Bahrain and the UAE made an attempt in this direction during 1977 when they agreed that a limited number of Bahraini dinars could be used as legal tender in each of the other countries without the need to exchange currencies. Another plan, under study for a number of years, is the establishment of a united Gulf dinar, which would be adopted as the main legal currency in all Gulf states.[10] The harmonization process clearly is advancing slowly, carried out through the newly established Gulf Cooperation Council (GCC), which aspires to a number of financial cooperation goals along with military and security considerations.

A final element in the OBU development process, possibly the most critical one, is whether a Saudi financial and capital market could emerge to eliminate the need for the Bahraini OBU market. Unfortunately, the nature and character of such a market is difficult to predict because of the prohibition of interest in the Saudi financial market. If Saudi Arabia were to initiate this market, it would have to be basically interest-free, contrary to the current interest-dominated nature of the Bahraini OBU market despite the presence of Islamic banks in Bahrain. At present it appears that only a non-interest system could emerge in Saudi Arabia, and very few alternatives could be found other than a system marrying the traditional banking structure with that of the Islamic system.

The connection between the Saudi and Bahraini economies will continue, with Bahrain offering services of a traditional character and Saudi Arabia offering the investor an alternative system based on Islamic teachings and practice. If and when these two systems join to produce a comprehensive one it could result in a major advance in the banking world. The basis for future cooperation could be to take only the best and most acceptable aspects of each system, recognizing the danger that orthodox ideologists in each system would

oppose conciliation. In any case, it can be anticipated that SAMA eventually may be reconciled to such a mixed system, and possibly would encourage its existence by allowing funds from each financial system to be freely available to the other.

INTERNATIONAL BANKING UNITS

Role of the Arab International Banks

The development of Arab and Saudi international financial institutions has progressed through a number of stages, as has the financial system generally. To place this international banking institutional development in perspective, it is useful to discuss the philosophy and recent history of the Arab and Saudi international banking movement and to evolve general development categories which make possible an understanding of the role and growth of each of the institutions to be discussed below. The first institutional development is that of the pan-Arab international consortium institutions such as the Gulf International Bank, which have generally evolved towards a regional presence, following the development of OPEC and the increased price of crude oil since 1973. The second development is the evolution of the specific country-owned banks such as the Saudi International Bank, primarily located in Europe. These institutions, along with the multi-owner OBUs discussed previously, conduct the majority of the international banking activities in the Arabian Gulf. The third institutional development is the offshore activities of the traditional commercial banks, such as National Commercial Bank, which gradually have evolved into international as well as local banking operations.

Arab international banking and investment institutions originally developed in the mid-1970s from a desire to serve Arab Middle Eastern government customers seeking investment and business outlets for oil surplus funds. As the investment recycling process expanded there was a need to identify and organize additional new investment opportunities, especially for private sector investors, and local Arab banks responded by forming consortium arrangements with Western and other Arab commercial banks. While serving as a training ground for young Arab bankers, they continued to utilize a majority of expatriate managers and other Western advisors, causing some critics to question the validity of these banking operations as they attempted to obtain central bank approval to operate as full service banks in several Western countries.

While the consortium banks and other Arab international banks still provide important links to the Middle East in many banking and other financial activities, they also hold the potential for a negative as well as a positive banking impact in the region. Specifically, consortium banks have been a significant element in the flight of capital from the region, with over 35 Arab banks in Paris and 50 in London. Most of the growth potential for the Arab international banks is tied to the deposits from individuals in Saudi Arabia and other Arab oil-producing countries seeking international investments with funds which

otherwise could be beneficial in local economic development. Significantly, they have entered Eurobond and Eurocurrency money and capital markets in the search for diversification of profits from local trade financing and contract guarantees which also are part of the financial recycling process. Further, they have pursued potentially profitable investment options in competition with established national and international banks which often possess considerably more experience and knowledge of the financial markets.

One of the main problems for the Saudi international banking operations is that in entering the international capital marketplace they must overcome the accumulated forces in opposition to changes in banking. Most banking relationships in the Arab world are based primarily on personal recommendation, a situation which does not necessarily work in favor of some of the international banks since they must demonstrate an ability to provide complete confidentiality. This is especially important for customers who are interested in high liquidity and good returns, and believe these are primarily available only through investments in several Western nations and do not wish to deal with a bank that could supply information on their investments to government or other agencies.

The significance of the Saudi international banking activities is that they provide a means of diverting funds which is not available to customers in Saudi Arabia, either through Bahrain or directly into the Western markets. The question is whether these banks, and Arab international banks in general, will be able to develop the personnel, knowledge, and network required to remain a viable force in the international financial market. Since these organizations depend to a great extent on expatriate management and Saudi capital, they possess only part of the equation for international banking success. They still must obtain a foothold in the most important market, international corporate borrowers, to compete effectively in the long run.[11]

Some Western governments and banks believe that the Saudi government is competing unfairly because, through SAMA, it has directly entered the corporate international borrowing market, or it has indirectly entered it through the private and consortium international banks. The result appears to be a growing politicization of the international financial marketplace. Possibly the prime example is the claim that SAMA is acting virtually as a merchant or investment bank. SAMA directly owns 4.9 percent (5 percent requires public notification) of many of the top US banks and has a large shareownership in companies including Eastern Airlines, Texaco, Getty, Mobil, Exxon, and likewise shareownership in Hitachi, TDK, and other Japanese companies.[12] While most of these arrangements are carried out through private channels, it is clear that the purpose is a legitimate effort to diversify government assets into stable, short-term, interest-bearing securities. SAMA recognizes that such activities provide the only logical means to enter the Western capital markets, given the export/import relationship between many of these companies and the kingdom and the relative lack of investment sources in Saudi Arabia. Accordingly, since SAMA and the Saudi government cannot yet fully staff the Saudi international

banking institutions with Saudi nationals it would be difficult to believe that they would even attempt to translate partial ownership of US banks and companies into management control.

To relate this discussion to the general development of the Saudi financial system, it appears obvious that, despite the concern of some Western governments and business leaders, Saudi international banking operations have not taken over any significant share of the international capital markets.[13] In fact, during 1982–1983 the continuation of relatively high interest rates was a major factor behind a slowdown in the Arab bank international money market borrowing activities. The situation was further exacerbated by the recession-driven oil glut of early 1982 which considerably slowed Arab investment activity in order to ensure support for development activity at home. While the development banks have continued to maintain their role in assisting Islamic countries with oil deficits, even this activity is beginning to roll back. Saudi Arabia and other Gulf countries have continued to move towards more effective nationalization of their international banking operations, but they have been unable to achieve this goal to the degree hoped for earlier due to the lack of trained Saudi and other Arab banking managers and specialists. During the past few years there have been expressions of concern in the West that OPEC and Middle Eastern oil profits could be translated into financial control of major multinational corporate enterprises. This view lacks substance because there was evidence during 1982–1983 that the Saudi international banks, along with the Saudi government, considered the international capital markets to be too complicated and risky, with the result that the banks resumed the earlier pace of activity in trade finance.

International Consortium Banks

The original Arab and Saudi international banks were set up as international outlets for offshore credit development, usually in conjunction with a foreign bank. While the average size of the consortium banks was and is small by Western standards, they tend to demonstrate considerable regional power. The Saudi international banking operations were quite active in developing the original consortium arrangements. For example, the French holding company partner in the largest French–Arab consortium bank, Union de Banques Arabes et Françaises, has sold out to its Arab partners after a history of cooperation since the 1960s. Other consortia are in a similar stage of evolution as the Arab partners begin to take the opportunity to go on their own.

The consortium banks, mainly directed from Paris, were active for several years after 1973 due to the need for the Saudi international banks to cooperate actively with an established international bank in order to enter the market and succeed against entrenched competition. Unfortunately, these facilities primarily drew their loan funds from interbank deposits, giving them very little meaningful leverage in the marketplace as they borrowed on short-term arrangements and loaned for longer terms. Further, consortium banks have been accused of engaging primarily in trade finance, with the parent bank taking the good business and leaving the remaining business for the other shareholders.[14]

The Bahrain-based Arab Banking Corporation, with a paid-in capital of $375 million, is the largest Middle Eastern consortium bank, and Gulf International Bank is the second largest, with a 1979 paid-in capital of $270 million. Both banks have been active in construction and foreign exchange and treasury-type financial services for Middle Eastern clients, but they are quite different from the earlier consortium banks because they operate largely from the Arab Middle East and focus their revenue-generating activities also on the Middle East. With branches in several large money centers and considerable involvement in commercial, investment, and wholesale banking, ABC and GIB truly are international banks. Despite the fact that ABC's main joint venture partners are the governments of Kuwait, Libya, and Abu Dhabi, and GIB's sponsorship is even more extensive, both ABC and GIB are small by international standards.[15] Their main strength is that they are large enough to avoid the problems of the smaller Arab consortium banks which can absorb and utilize only a small percentage of the total oil surplus. Because GIB and ABC are becoming increasingly aggressive in money market operations and have firm commitments from their shareholders, the opportunity to advance is clearly greater than for the smaller Arab consortium banks with less firm support from shareholders.

During 1981 ABC and GIB were among the top 50 banks in the world involved in lead-managing Euroloans. ABC was ninth and GIB was seventeenth on the lead-manage list through the first 6 months of 1981. ABC was lead manager in 34 loans totalling $9541 million and GIB in 33 loans totalling $6690 million. This is a significant feat given that in 1979 there were no Arab banks among the top 50 lead managers. The broader perspective for this development is that 45 percent of the publicized Euroloans in the first half of 1981 had Arab bank lead managers, compared with 6.5 percent in 1980. While the growth rate declined in 1982, the overall trend is in line with the desire of Arab governments and international banks to achieve an increasing share of the international banking activities in the Middle East. There is considerable logic behind these efforts, but there have been questions about the ability of these banks to enter the international capital markets. It is clear, however, that the banks and their government supporters require substantial international connections if they are serious in attempting to provide the financing and investment channels for trade finance, guarantees, and capital market development.[16]

Overseas Saudi International Banks

Apart from the Arab megabanks – Arab Banking Corporation and Gulf International Bank – the Saudi international banks provide one of the most intriguing and high-potential, yet least understood, financial system banking

developments in Saudi Arabia. These organizations have conducted most of their banking functions outside Saudi Arabia, but they have acted as important financial conduits for Saudi and foreign firms doing business in Saudi Arabia. Consortium or quasi-merchant banks, the Saudi International Bank and Al-Saudi Banque, have performed an increasingly significant role in Eurobond and other financing activities over the past few years.

The international financial market activities of the Saudi domestic and foreign banks, which are directly or indirectly controlled through SAMA and the Ministry of Finance, are beginning to present a challenge to ABC, GIB, and other Arab international banks. A group of Saudi banks, with considerable government ownership or direct financial involvement, operate entirely outside Saudi Arabia but draw on Saudi funds or Saudi sources of economic activity for much of their business. The Saudi international banks have operated much like the pan-Arab international banks which are owned by various Arab governments, including that of Saudi Arabia. They have successfully entered Euromarket loan syndicates to engage in project and trade financing as well as Eurobond trading, largely due to the high level of government support and direct funding. Gradually entering the American and Far Eastern money and capital markets, these banks have joined ABC, GIB, and other leading Arab international banks. Especially important in this process is the Saudi International Bank (SIB), of which SAMA owns 50 percent, Morgan Guaranty Trust owns 20 percent, and National Commercial Bank owns 2.5 percent. SIB is the largest Saudi international banking facility operating outside Saudi Arabia, surpassing the Paris-based Al-Saudi Banque (ASB), which in 1981 joined SIB as the most important Saudi international banks headquartered outside Saudi Arabia.

Among the unique characteristics of ASB and SIB is that they each have wide diversities of individual, company, and Arab central bank depositors. Further, they have been successful in resisting the easy route of money market funding activity followed by many other Arab consortium banks. SIB and ASB have oriented their flows of central bank funds towards highly selective money market activities while directing their private institutional and individual account funds into various loan portfolios. With branches in the major money market centers of Europe and the USA, SIB and ASB have increased their assets considerably since 1978. Their main strength is in the diversity of their asset bases, drawing deposits from approximately 70–80 nations, with the Middle East comprising 40–45 percent of the total and 50 percent of the Middle Eastern portion coming from Saudi Arabia.[17]

SIB has an especially important role in international finance; it is placed in London to support the London offshore Saudi riyal market. SIB is closely involved in the substantial riyal dealings moving through London, and its growth is a product of SAMA's desire to have access to the international markets through a Saudi bank in London. SIB activities thus effectively stabilize riyal rates, enable increased riyal market participation, and prevent speculation on the riyal. While SIB primarily engages in trade financing and

other Saudi government international business, it also conducts considerable merchant banking activity, including private corporate placements. Despite the fact that SIB has been considerably underloaned, and has encountered much competition from British banks, it has been able to expand considerably its capabilities in trade finance and personal financial services.

Offshore Banking Activity of the Saudi Commercial Banks

The link between the Saudi international banks and the international banking activities of the Saudized domestic commercial banks is significant and best described in the relationship between the National Commercial Bank and Saudi International Bank. NCB is a prime conduit from the Saudi government and non-government depositors and, through this and its 2.5 percent share-ownership in SIB, has developed extensive ties with the Western banking system. In addition, NCB, with an established presence in Bahrain through the wholly owned Saudi National Commercial Bank (SNCB), and NCB offices in Frankfurt, Singapore, London, and Seoul, engages in additional international Saudi riyal support activity. SNCB, which is now one of the largest Bahraini OBUs in terms of deposits and assets, started its development in the money markets but now has moved into medium-term riyal financing for corporate clients, directly or indirectly through the client's bank. Using a combination of loans, swaps, and medium-term forwards, SNCB has evolved a balance sheet which is composed of approximately 30 percent US dollars and 55 percent Saudi riyals. SNCB thus has joined SIB and ASB as key elements in SAMA's drive to monitor and control the offshore riyal market.[18]

The tie between NCB and the Saudi International Bank has created stability in the Saudi international banking system as well as in the Saudi domestic financial system. While there is communication and some shareownership connection between SIB, SNCB, and NCB, there is not a direct monetary connection such as exists within most international banking operations. The contact is through various syndication and direct-lending activities, but each bank maintains a sovereign or independent risk relationship. Consequently, NCB is able to concentrate on development of the domestic Saudi market, especially the small businessman, while SNCB and SIB operate in the international banking sphere. This is a significant switch from several years ago when NCB's international banking strategy was basically participation only in a limited number of pan-Arab bilateral bank consortia.[19]

Gulf Riyad Bank provides another example of Saudi international bank riyal support. Gulf Riyad Bank was registered in Bahrain in 1978, with Riyad Bank majority ownership (60 percent) and partial SAMA control through its large financial involvement in Riyad Bank. Gulf Riyad Bank provides SAMA with a direct window on Saudi riyal international activity throughout and beyond the Gulf. For example, in 1980, the first year of international finance activity for Gulf Riyad, the bank was involved in $33.33 million in international syndicated loans. However, by 1982 the amount of syndicated loans which Gulf Riyad

managed had risen to $130.28 million, placing it as fifth among the Saudi banks in international syndicated loans (see Table 4.1). More importantly, Gulf Riyad Bank was active in developing a portfolio which in 1980 was composed of $214 million medium and long-term loans, $26.8 million in short term Saudi Riyal and dollar loans and $14 million in regional guarantees, bid and performance bonds.

Performance of the Arab and Saudi International Banks

The major Saudi and Arab international banks have, over the past few years, experienced growth that in many ways is similar to that of the Saudi commercial banks, but with notably lower returns despite increases in assets, equity and deposits. While all balance sheet items have grown, the rate has been on a downtrend since 1980 due to the decline in syndication margins. Profit growth results thus have been mixed for the Saudi overseas banks, including ASB and SIB, due largely to the fact that international banking development tends to be oriented more toward market share than short-term profits. While the size of the two large Arab regional banks (GIB and ABC) has enabled them to grow, it has been at a lower rate than most Saudi Arab commercial banks.

Since much of the asset base of the Arab and Saudi international banks, especially the long-term portion, is associated with syndicated loans it should be analysed for its impact on revenue and profit performance. The international syndicated loan market has provided a ready-made money market in which the nations producing a surplus of oil could test their abilities in international banking. These banks lead-managed or shared in the float management of over $19 billion in the international syndicated loan market during 1981 and 1982.[20] The Saudi commercial and international banks share a substantial role in the syndicated loan market, contributing to a growing percentage of the total. These banks and other arab banks have combined with GIB and ABC to become a notable force in the internationalization of Arab OPEC oil funds. The Saudi banks held 10 of the top 50 positions among Arab banks in the 1982 international syndicated loan market, indicative of their growing exposure in the marketplace. This position became more noticeable with the relatively sharp drop in international loan syndicate activities in 1982 which carried into 1983. Originally, the assessment was that there were seasonal problems and shifts, but gradually the reduced cash flows associated with the decline in oil sales has hit the main producers. In early 1982 the Arab syndicated loan rankings included the following: (1) Arab Banking Corporation; (3) Saudi International Bank; (4) Kuwait Foreign Trading, Contracting; and Investment Company; (5) Gulf International Bank; (8) Gulf Riyad Bank; (10) Al-Saudi Banque and National Commercial Bank.[21]

Profits for the Saudi international banking operations have increased since 1978, even with high international interest rates. Accordingly, the lure of international competition, despite the low spread in the syndicated loan markets, encouraged GIB and ABC initially. But recently they have attempted

Table 4.1 Bank syndicated loans (selected Saudi/regional banks) ($ million)

	1979			1980			1981			1982		
	Loans LED*	amount	% share	Loans LED*	amount	% share	Loans LED*	amount	% share	Loans LED*	amount	% share
Gulf Int'l Bank	12	344	49.86	34	743	41.13	60	1 280	29.08	58	1 357	28.30
Arab Banking Corp.	−1	0	0.00	12	387	21.40	68	1 547	35.12	46	1 237	25.79
Al Saudi Banque	1	30	4.35	5	23	1.28	21	456	10.35	13	246	5.13
Saudi Int'l Bank	1	16	2.29	15	363	20.09	26	393	8.92	20	470	9.81
Nat'l Comm'l Bank	5	201	29.09	11	213	11.78	16	308	7.00	21	917	19.12
Saudi Amer. Bank	0	0	0.00	0	0	0.00	10	120	2.73	15	288	6.01
Saudi Invest. Bkg Corp.	2	36	5.19	0	0	0.00	2	84	1.91	2	25	0.52
Saudi Brit. Bank	1	5	0.75	0	0	0.00	1	64	1.46	2	7	0.14
Saudi Cairo Bank	0	0	0.00	3	15	0.81	1	58	1.33	3	37	0.78
Gulf Riyad Bank	0	0	0.00	3	33	1.84	1	8	0.18	6	130	2.72
Arab Pet. Invest. Corp.	3	58	8.47	1	30	1.66	3	85	1.93	4	79	1.65
Saudi Dutch Bank	0	0	0.00	0	0	0.00	0	0	0.00	1	1	0.03
Total	24	690	100.0	84	1 807	100.00	209	4 403	100.00	191	4 794	100.00

* LED = lead managed.

Source: Based on Middle East Economic Survey, various issues, 1979–1983.

to realign their investment strategies towards short-term arrangements and the more stable profits which have been made in letters of credit, guarantees, and direct placements. For example, in Bahrain 30 percent of the loans for the first 6 months of 1981 were direct placements which, when combined with the fact that time deposits increased 59 percent to $3.2 billion, enabled balance sheet assets to increase 64 percent from the same period in 1980. This, along with the fact that the Arab international banks appear to be looking to the Far East as the next major market to augment their substantial investments in the Western economies, is a significant indicator of future international banking activity.

The forecast is that Saudi government and private investors will continue to seek solid, equity-type investments. Also, the government and private investors have begun to identify investment opportunities in non-dollar environments such as Japan, Hong Kong, and Singapore, based on the view that there is more future potential in the developing Asian economies. There is, in this process, evidence of the continued positive evolution and sophistication of Saudi international financial activity and prospects for further involvement in various non-dollar international investments which enable diversification of the Saudi economy.

OTHER MONEY MARKET INSTITUTIONS

Money Exchangers

The money exchangers are the oldest known financial institutions in Saudi Arabia, originating in the effort to serve pilgrims who came to Mecca with different currencies from all over the world. Yemeni nationals, who once formed the largest single foreign expatriate community in the kingdom, provided the money exchangers with much business as they remitted funds to their families or bought Yemeni riyals on their way home. After stability returned to the kingdom under King Abdul Aziz, more pilgrims came from other countries, bringing their currencies or gold and silver coins. As business thrived, more money exchangers came into the market, including Saleh and Sulaiman Al-Rajhi, Al-Subeael, Bamaodah, Mukairen, Al-Amoudi, and Bagalaf. The Al-Rajhis became the largest money-changing establishment, with over 100 branches in the kingdom, and today they run the largest money-changing operations in the country if not the world. This successful and unique organization has accounts in many countries and deals in virtually every conceivable currency. The declared capital of the Al-Rajhis in mid-1980 was SR 600 million, and their total assets are reported to be in excess of SR 5.5 billion.[22]

The money exchangers are, by law, primarily restricted to accepting demand deposits and exchanging foreign currencies. They are not allowed to buy dollars from SAMA or to issue letters of credit and guarantees. In practice, however, the money exchangers, who are the only bankers in many remote areas of the kingdom, perform just about every function normally handled by the commercial banks, and effectively overcome the restriction on dollar purchases by buying from the commercial banks. Several of the money exchangers have operations larger than some of the commercial banks, and it is estimated that the market share belonging to the money exchangers is large – between 20 and 30 percent of total bank deposit and loan activity.[23]

The profit picture for the money exchangers varies considerably in content and amount. The spread on currency exchange and the commissions on services rendered, such as buying foreign currencies and issuing travellers' checks, are much smaller than the corresponding fees charged by the banks and provide the larger exchangers with a significant pool of short-term, interest-free money. Generally, exchanger rates reflect the real currency rates or market rates and not the official rates set by the government. Despite this, commissions are considerably higher on the opposite side of the transaction, such as the buying of Saudi riyals with foreign currencies or checks. However, since riyal purchase represents only a small volume of total transactions it detracts little from the generalization that the exchangers usually are more competitive than the commercial banks.

The activities of the exchangers are on the whole very profitable as a result of their low cost of operations and money, along with the fact that their customers often are unwilling to accept interest or refuse to do business with commercial banks. The money exchangers have also been able to show strong profits because of the high volume of activity on relatively low asset and equity basis. The rate of growth and the high return on invested capital are also partly attributable to the rapid pace of industrialization which has added to volume levels and the increase in the number of foreign workers in Saudi Arabia.

Money exchangers, particularly the larger ones, have operated in a relatively unregulated environment where they issue money drafts, deal in precious metals, and occasionally even arrange letters of credit. Until recently there have been no reporting requirements, no published balance sheets, and not even any clear legal control of the activities of the money exchangers. This situation has caused the Ministry of Finance and National Economy to initiate regulations on the money exchangers, with full control a government objective during the Third Five-Year Development Plan period.[24] The Ministry of Commerce until late 1981 issued licences for the money exchangers, with only minimum financial requirements. The freedom from reserve and other banking restrictions has also become a serious source of concern and annoyance for SAMA, which considers regulation of the money exchangers to be an important aspect of the future development of the private financial system.[25] Consequently, the strict new rules on the exchangers, which take effect at the end of 1983, will make them subject to the reserve requirements already imposed on the commercial banks. However, the money exchangers have a reputation for integrity, honesty, and reliability. It can be expected that until fully regulated they will continue to expand and diversify their activities. Part of the expansion has been into Islamic-style investments, with Al-Rajhi leading the way into Islamic inventory purchase agreements. Thus Al-Rajhi agrees to buy a commodity such as oil, holds the cargo for a few days, makes a sale to the

customer, and delays payment until receipt of the goods: essentially a normal trade financing arrangement with an Islamic option.[26]

Representative Offices of the Islamic Banks

The other financial institutions operating in Saudi Arabia include representative offices of Islamic banks and investment companies. The kingdom's identification with Islamic principles and the official prohibition of paying and receiving interest in government financial transactions, including those related to SAMA and the commercial banks, may have been the reason for not licensing Islamic banks to operate in the kingdom. The only Islamic bank that operates in the kingdom is the Islamic Development Bank (IDB) in Jiddah. The IDB is owned by several Muslim governments, including Saudi Arabia which owns 25 percent of the IDB's total authorized capital. As its name implies, the IDB is not a commercial bank and therefore is not subject to Saudi banking regulations. Actually, it is an investment fund managed by representatives of the Muslim governments for the purpose of promoting economic development and social progress in the member countries and Muslim communities. The IDB, however, has introduced a short-term investment deposit scheme whereby funds are generated through the issuance of Investment Deposit Certificates. These funds are utilized in the foreign trade financing operations of the bank in accordance with Islamic principles. The IDB uses the Gulf International Bank in Bahrain for the purpose of collecting receipts and effecting payments related to the investment deposit scheme. However, the IDB deposits most of its cash funds with SAMA.

The Islamic Investment Company (IIC) is another Islamic financial institution that generates funds from Saudi Arabia through its ten operating branches in the major cities of Saudi Arabia. The IIC, in January 1982, became a subsidiary of Dar Al-Mal Al-Islami, the largest Islamic financial institution in the world, with headquarters in Geneva. The number of IIC operating branches in the kingdom increased to 24 by late 1982. These branches have a 'quasi-legal' status and operate under the sponsorship of Prince Muhammad Al-Faisal Al-Saud, a Saudi promoter of the Islamic banking and economic movement. The IIC is quite active in marketing and promoting its operations in the kingdom and the Arabian Gulf area. Appeals for investment in Dar Al-Mal Al-Islami savings accounts, time certificates, and cooperative life insurance center around the prohibition on receiving or paying a fixed rate of return (interest) on the accepted deposits in accordance with the Islamic Shariah, with the depositor relying on the profit generated from the invested funds which fluctuates every month. Dar Al-Mal Al-Islami stocks, sold through IIC offices, rely on a return generated from the profits and appreciation in the market value of its shares. In fact, the 24 representative branches of the IIC are competing for funds with the commercial banks in Saudi Arabia.

In brief, the two major Islamic financial institutions that compete for funds in Saudi Arabia are the IDB, through its short-term Investment Deposit Certi-

ficates, and the IIC, through its short- and long-term deposit schemes, savings accounts, time and investment certificates, and cooperative insurance subscriptions. These two financial institutions do not provide conventional loans and banking services but basically rely on the Islamic consciousness of Muslim depositors in Saudi Arabia. Their success, however, depends on their ability to offer customers competitive returns through investment of the deposited funds in profitable projects. The method of operation, past performance, and the prospects of the IIC and the IDB, along with the other Islamic banks, are discussed in Chapters 6, 7, and 8.

DISCUSSION QUESTIONS

4.1 Describe the influence of Bahrain offshore banking units on the Saudi money market institutions.
4.2 What major benefits do the OBUs provide to the Saudi banks?
4.3 Discuss the effect of the banking powers given to the Bahrain Monetary Agency.
4.4 What are the problems encountered by the Bahraini OBUs that will limit their future growth?
4.5 In what ways has SAMA used and relied on Bahraini OBU services? Discuss.
4.6 Describe the activities of the Saudi OBUs and state their effect on the Saudi financial system.
4.7 What is the role of the Arab international banks in the international capital market?
4.8 What is the significance of the Saudi international banking activities and what are the problems faced by the Saudi international banks?
4.9 What is meant by 'international consortium banks?'
4.10 Discuss the major success areas of the Saudi international banks.
4.11 What are the major offshore banking activities of the Saudi commercial banks?
4.12 Evaluate the overall growth and results of operations of the Arab and Saudi international banks.
4.13 Describe the history and role of the money exchangers in Saudi Arabia.
4.14 What are the main reasons for the profitable activities of the Saudi money exchangers?
4.15 Discuss the major role of the representative offices of the Islamic banks in Saudi Arabia.

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CHAPTER 5

Saudi Capital Markets

The structure and efficiency of the financial markets in any economy are largely dependent on the banking system, and in Saudi Arabia this is no exception. While the dominating force clearly is the Saudi Arabian Monetary Agency, with policy direction coming from the Ministry of Finance and National Economy, the role of the commercial banks is the critical variable in the success of the system. Consequently, the contrasts between the Saudi financial market system and those of other countries are worth considering and provide some interesting bases for thought in the future. This chapter

(1) considers the various stages of financial market development which have occurred and are occurring in the Arab Middle East and Saudi Arabia;
(2) identifies some of the factors in the generation of loanable funds in Saudi Arabia;
(3) discusses the basis for some recent money market developments in Saudi Arabia, and assesses these activities in terms of their impact on the economy;
(4) develops the basis for a comparison of Saudi financial market development with that of other developing economies, using the example of Kuwait.

The financial market concept has many facets which have considerable significance in Saudi Arabia. Today, the financial market basically involves only the flow of loans, commercial and private, and the money supply. While no effective internal secondary money or capital market exists, due largely to the fact that the internal (domestic) use and acceptance of interest on capital is not permitted by Islamic law or SAMA regulations, there is a small emerging stock market, trading in a few bank and company issues. An informal operation, the stock market is maintained by the originating banks and firms and a few traders. The other financial market, real estate, is active but unsophisticated and oriented more towards speculation than development. There are plans for expanding financial market operations during the third development plan, but effective equity markets will take much longer to organize.

The development of efficient financial markets in Saudi Arabia requires consideration of a number of important variables which will determine the

ultimate success of the kingdom's economic diversification program. Saudi Arabia has great potential for development, but the future depends upon full utilization of the oil revenues. One means by which these revenues can be turned into effective operating and capital assets for the private sector is the financial market activity generated through the banking system.

DEVELOPMENT FRAMEWORK

Financial market activity in developing nations is a reflection of the stage of economic development and the levels of specialization accomplished in the growth of the market economy of the country. In the Arab nations of the Middle East there are examples of most of the development phases or stages, but there has been uneven private sector economic activity in the region.

The first development stage is that of self-sufficiency, and the nations in this category have the most to gain, receiving much attention from the industrialized nations and Arab development funds. These self-sufficient financial market economies serve only domestic lenders and borrowers, and neither seek nor can expect to respond to any outside demands or opportunities. Among the nations which could be placed in this category are Algeria, Iraq, Oman, and the Yemen Arab Republic.

A second stage in financial market development in the region is reached by an economy that remains overly self-sufficient in the supply of funds but seeks to utilize a portion of these funds beyond the country's national boundaries. Kuwait is the most obvious example of this stage due to its emerging money and capital markets and investment activities. Other candidates for this classification include the United Arab Emirates, Qatar, and possibly Saudi Arabia.

A third development stage, which is considerably more advanced in the sense that it points the way to future financial institutional growth, is found in Egypt and Jordan. In these two countries the financial markets may occasionally encounter heavy demands for funds without being able to meet them from the internally generated flow of funds. As a result, there could be an inflow of funds from the surrounding region, especially from countries with an excess of funds.

A fourth stage is an increasingly important one which today is performing a major role in assisting the flow of funds within the region, with Bahrain the prime example. Here the financial markets have grown by drawing on external funds and by meeting external funds demands. Bahrain's active international investment and commercial banking community has drawn funds from the entire region and organized financing arrangements with international parent consortia and correspondent banks.[1]

FINANCIAL MARKET PROCESS

The commercial banks are critical in the progress of the market economy through the development stages. It is the commercial banks which create the

financial instruments needed to attract surplus funds and initiate the various services such as underwriting, brokerage, and foreign exchange trading. This is, of course, the basis for secondary market growth. The banks at the same time will be the primary source of expertise for project evaluation and financial planning. This activity is a necessary basis for the market risk taking which is critical in the developing world. However, since commercial banks in Saudi Arabia are, as in most developing nations, oriented towards short-term lending, until the financial market system is well-established the banks cannot provide medium-term and long-term credit in the amounts required for effective economic development. Consequently, the government specialized credit agencies will continue for the indefinite future to effect the required blending of private and public sector credit activity.

Most countries in the Arab Middle East have similar programs and goals in the development and use of their commercial banking systems as means for aiding development and economic diversification; the only major difference is in the ability to pay for the projects that make up their ambitious program goals. The Saudi Arab development process is unique in many ways, especially in the desire of the government to transfer the oil revenues back to the citizenry to effect productivity-enhancing economic diversification. The banking system is, of course, the most important money market institution in this process, and the Bank Saudization Act of 1976 was designed to accomplish this goal as well as to make the foreign banks operating in Saudi Arabia politically and financially independent and more effective. Saudization was tantamount to placing the banks under the Saudi Arabian Monetary Agency and eliminating foreign direction of the financial markets. Thus far the results have been encouraging but not uniformly positive in their impact on the economy.

The Bank Saudization Act, intended to influence the operation of the money markets in Saudi Arabia, operates by placing emphasis on medium- and long-term capital financing as opposed to heavy orientation towards import trade finance. The Saudization Act also sought to end the foreign international bank practice of continually transferring excess funds abroad to the parent banks. Providing a means to turn over control of the banking and financial system to Saudi citizens, the Saudization Act has enabled the Saudi investor to put his savings to effective use and opened the door for further efforts to achieve a long-term lending and capital market.

Development of a medium- and long-term money market depends on cooperation between SAMA and the commercial banks. The banks must be willing and able to extend term and longer loans to the private sector. But some bankers are seriously concerned about the competence of local borrowers and their ability to utilize resources efficiently. Thus the banks have set up only short-term, very liquid, minimum- risk loan arrangements. There is, as a result, a degree of instability and underachievement in private sector and national economic goals. The conservative loan policies of the commercial banks thus indicate an inherent lack of confidence in the economic system, which in turn prevents the development the banks expect to support their loan-backing

requirements. This has been seen as detrimental to the kingdom's long-term growth and diversification.

Bank Saudization is broadening the ownership of the banking system, and the expectation is that it will lead to growth in the availability of medium-term credit. Whether there is or will be a direct correlation between Saudization and the increase in medium-term loans is questionable. Rather, the long-term expansion in medium-term loans will be due, more likely, to a combination of economic factors related to the overall growth of the economy and Saudization. Of primary concern is the fact that with Saudization the banks have been allowed to increase their capital base and consequently the loan levels, in accordance with Article 8 of the Banking Control Law (see Appendix B) which limits loans to any one individual or corporation to 25 percent of the capital and reserves of the bank. This, along with other SAMA changes in reserve requirements, has enabled the banks to begin increasing loan amounts and maturities and to participate in loan/bond syndications.

While this process has effected a modest liquidity expansion, the banks still seek high collateral, personal, and corporate guarantees and strictly administrate the loan funds payouts. The government, through the five-year development plans, is providing the impetus to change this attitude. The third plan, for example, calls for further development of industrial joint ventures between Saudi and outside firms, adding confidence to the economic environment. To ensure success in this activity SAMA must permit enough flexibility in bank credit and currency regulations for the banks to respond to various medium- and long-term business investment opportunities. Of course, SAMA also has an important role in preventing the banking excesses that can and have occurred in the past in Saudi Arabia and several other Arabian Gulf countries. Consequently, SAMA's regulatory activities cannot be considered as completely negative.

An indication of the success, and potential for further success, in the expansion of long-term bank credit is the fact that some Saudi and Saudized banks have been financing capital equipment sales in the kingdom. The basic problem with this activity is the lack of experience of and liquidity in the local banks. As a result, the banks are unable to respond effectively to the demand for longer-term loans, or to provide grace periods and other such services. Much of the problem also derives from the lack of company account receivables identified as security to pay off the loan. Despite these problems, local banks have moved to respond positively by

(1) hiring experienced expatriate loan officers capable of generating new medium-term business;
(2) scheduling loan repayments on a monthly and quarterly basis (as opposed to 'pay as you can');
(3) requesting compensating balances to help overcome occasionally significant short-term liquidity problems;
(4) establishing precedent conditions on dividend payouts and other bank

financial controls, and granting balance sheet based medium-term loans to quality customers.

Thus, despite the many limits on bank loan expansion into fixed assets, there has been considerable progress.

An important aspect of the Saudization and medium-term lending process is that the banks have become more aggressive in responding to various opportunities, and nowhere has this been more true than in programs involving capital equipment sales through the country of origin of the Saudized joint venture banks. These arrangements have become significant as the country of origin sees a possibility to make commodity sales and is willing to provide the bank with information and financing assistance through an export–import type bank or government support on the loans. Obviously, political considerations have been important here, but an avenue has been provided for mutually beneficial trade and financing activity.

Another area of development which has helped to increase medium-term commercial bank loans is the growth of restrictions placed on government funding or specialized credit agency loans. For example, Saudi Industrial Development Fund loans for medium and small industrial facilities are for only a maximum of 50 percent of the cost of the facility. In addition, the time required for approval (6 months to 3 years), and the cost of the required feasibility studies (SR 10 000–30 000) for even small projects, is making the investor think carefully about taking the government loan route. The result is that it sometimes may be easier for a prospective borrower to work through a commercial bank with which he may already have contact than to attempt going through a specialized credit or funding agency.

Even though there has been a considerable amount of funding agency medium- and longer-term loan activity over the last few years, the commercial banks have made some significant strides, as indicated in the growing number of loan syndications. The increasing size of loan applications has made it difficult for all but the kingdom's largest commercial bank, the National Commercial Bank, to handle the majority of acceptable opportunities that are available. As a result, most of the banks have been participating in loan syndications to spread the cost and risk, with apparent good results. Since the risk is not exceedingly great, the number of opportunities significant, and the number of banks small, the interest in and reasons for syndication are weighty. Also, the impact of offshore banking unit competition in loan activity has forced the local banks to participate to serve their local customers or risk losing both the loan possibilities and the low-cost deposits from those same customers.

A final note on this subject concerns the question and problem of interest in the development of the medium-term loan market in Saudi Arabia. High interest rates inside and outside the kingdom have meant that longer loan terms increase the risk potential and interest lost to the banks. This has caused the financial markets to utilize options outside the kingdom, which has brought about effective internationalization of the riyal. This has led SAMA,

effectively, to impose currency controls, and thereby delay the industrial diversification effort and development of the banking system. The interest controversy held the banks to short-term, highly liquid loans and services which earned a service fee instead of interest until they were Saudized and faced significant competition for deposits and other business. While Saudization made it possible for them to increase their capital bases and promulgate various innovations in response to the limitations placed by SAMA, the financial markets in Saudi Arabia continue to operate without purpose and conviction.

SAMA's interest and concern in the capital availability process has resulted in efforts to expand considerably its role in attempts to facilitate the future development of Saudi financial markets. It has been argued that SAMA and other government central banks in the Middle East are more like merchant banks than central banks in their operations, and that they have made loans and acquired real estate and securities, and engaged in other activities that a Western central bank would never dream of pursuing, for reasons of political and financial safety.

CAPITAL MARKET INTERMEDIATION

In the increasingly complicated Saudi Arabian financial system internal capital market intermediation officially is handled through the government specialized credit or funding agencies. In addition, a quasi-private investment bank and the informal stock market provide additional capital funding sources. These intermediaries are monitored carefully by SAMA, the Ministry of Finance and National Economy, and the Ministry of Commerce. Placed in perspective, the capital market in Saudi Arabia, providing primarily medium- and long-term loans and equity investments, gives the basis for long-term economic diversification and is the spur for private sector financial development. In contrast, the other capital market institutions, the international development agencies in Saudi Arabia and nearby Gulf OPEC countries, provide general capital funds which act as critical development catalysts for other Muslim and developing countries.[2]

The role of capital markets in economic development has increasingly been emphasized as an important tool of intermediation analogous to industrialization.[3] In a region that has been endowed with enormous wealth in a short period of time, and where recycling capital surpluses rather than deficits has been a problem, Saudi Arabia has not had the opportunity to appreciate fully the function and importance of such markets in its development process. Recent times, however, reveal growing constraints in the development of the kingdom's surpluses, with signs even of unprecedented deficits as the oil revenue boom runs down. A survey of the options available to contain this situation and simultaneously pursue the current pace of development reveals a number of possible capital market instruments, including government agency shares and local borrowing. Both of these options can be efficiently and effectively facilitated through the development of the necessary markets which

would serve to compensate investors for the risk and impose appropriate costs on the employment of capital.

With a recognition of the need, SAMA and several government ministries have recently moved to increase the study of the development of capital markets in the kingdom. A proposal emanating from a study sponsored by SAMA endorses the establishment of a company for recording and transferring stock shares, an activity which is planned to commence late in 1983. This is a direct result of the increased volume of shares traded and an indication of the regulators' interests in such activities.[4]

In an economy where banks and related financial instruments have substantial untapped capacity, as well as an increasing consciousness of the part of the private investor in search of safe and attractive returns, the development of financial markets is inevitable. While there are no organized financial markets for trading either short- or long-term instruments in the kingdom, this activity is undertaken by the Bahraini offshore market as well as other international financial markets. An advantage to be accrued from the development of a local market would be the stemming of capital outflows from the kingdom that could provide SAMA with the ability to have increased control over riyal-denominated financial activities. Thus, as a regulator of the financial environment, SAMA would be the main force behind the development and the determination of the scope of such a market.

In an environment laced with social bottlenecks and an absence of a complementary secondary market, and with related institutions impairing the development of financial markets, SAMA would have to undertake a major and unique role in developing innovative instruments and legal frameworks tailored to the environment. Further, as a major facet in the development of any capital markets, the absorptive capacity of the kingdom would have to be examined and coordinated with the activities of the capital markets to allow for a meaningful development of the economic base.[5] With no major natural resources other than oil, increased attention would have to be given to the development of the secondary and service industries, which would again entail a high level of coordination, involving SAMA and the various government ministries. In this regard, it is obvious that SAMA must perform a central role in the 'financialization' of the Saudi economy and hence its future stage and state of development.

SPECIALIZED CREDIT AGENCIES

Roles and Purposes

The primary vehicles for carrying out government support of private sector financial system development in Saudi Arabia are the specialized credit or funding agencies. Some Saudi capital market intermediaries in the kingdom have important roles, but the government specialized credit agencies have been especially active in extending credit to the private sector. At the end

of 1980 the balance sheet total of the funding agencies was approximately SR 87 000 million, exceeding the commercial bank total by over SR 21 000 million. The inability of the private banking sector to provide term credits to finance urgent private development projects led the government, through the Ministry of Finance and SAMA, to create six specialized credit agencies and the Arab Development Bank on models from other developing nations. The agencies are:

Public Investment Fund (PIF)
Saudi Industrial Development Fund (SIDF)
Real Estate Development Fund (REDF)
Saudi Arabian Agricultural Bank (SAAB)
Saudi Credit Bank
Credit Fund for Contractors

(See Appendix D for organizational details). These agencies obtain models from other developing nations and receive their capital and lending resources primarily from the government, basically providing:

(1) equity and loan support for major primary industries;
(2) medium- and long-term loan support for secondary industries;
(3) interest-free individual and commercial housing loans;
(4) agricultural development loans;
(5) credit support for local contractors;
(6) training and equipment loans for individuals commencing a business or trade.

Oriented towards injecting credit into the private sector, the specialized credit agencies indirectly and effectively expand the absorptive capacity of the economy.

Accomplishing a diversified industrial base in a nation with a single resource requires considerable participation of public as well as private investment, and this is the primary object of the six specialized credit agencies. These agencies performed an important economic diversification role during the second development plan, following the Islamic principle of granting loans without interest. According to Table 5.1 these agencies disbursed over SR 22 billion in loans during 1980–1981, nearly as much as the outstanding loans of SR 20 billion held by the entire commercial banking system in that year. The result is that the specialized credit agencies effectively became the conduit for government fiscal policy while also complementing the short-term credit activities of the commercial banks through their term financing activities.

Despite the important support the specialized credit agencies contribute to the kingdom's capital growth, there is no intention to substitute these agencies for the commercial banking system. For example, the Real Estate Development Fund has provided interest-free funding support for housing development and participated in a way that no commercial bank could match. A commercial bank could not afford to lend money without some compensation,

Table 5.1 Specialized credit institutions: loan disbursements and repayments (SR billion)

	1975	1976	1977	1978	1979	1980	1981*	1975–1980 average annual compound growth
Disbursements	5 723	15 664	19 560	17 267	19 014	22 365	17 506	25.50%
Repayments	31	199	531	959	2 228	2 428	2 733	106.85%
Repay. as % of disbursements	0.54	1.27	2.71	5.55	11.72	10.86	15.61	

* Three quarters only.

especially in an economy where the underlying inflation rate is between 5 and 10 percent. Interest-free industrial loans and financial assistance to poor and middle-class individuals who wish to obtain funds for legitimate development purposes also contribute to the economic growth of the country. The specialized credit agencies have advanced growth in the private sector and the financial system, but they are by no means a substitute for the long-term growth provided through an effective capital market. Table 5.1 shows that during the second development plan the funding agencies disbursed over SR 85 billion in various loan and equity arrangements.

Operations

Two of the funding agencies, the Public Investment Fund (PIF) and the Saudi Industrial Development Fund (SIDF), are important for their roles in effecting economic diversification as well as expanding the long-term credit base in the kingdom and the future secondary capital market which is necessary for completion of the kingdom's financial system. A brief review of the activities of these two agencies, followed by a summary of the financial results of these and other funding agencies, will indicate their significance in the development of the financial system.

The PIF provides loan financing and equity participation in a wide variety of economic development projects. While it provides equipment loans to Saudia, the Saudi national airline, and a number of other non-industrial projects, emphasis is placed on industrial programs handled by Petromin, the oil-refining and marketing arm of the Saudi Arab government, and the Saudi Basic Industries Corporation (SABIC). PIF makes loans, amounting to approximately 60 percent of total cost, to both SABIC and Petromin. PIF also purchases 15 percent equity shares from the joint venture partners involved with SABIC and Petromin in the primary industries being developed at the new industrial complexes in the Eastern Province (Jubail) and the Western Province (Yanbu). SABIC is responsible for all non-refinery primary industries

and has signed several agreements for petrochemical, fertilizer, methanol, and steel projects. Petromin, in addition to its joint venture projects, is responsible for the domestic refinery at Yanbu along with other refinery projects in the kingdom (Jiddah, Riyadh, and Rabigh) and the pipeline network which is under construction.[6]

Another area of responsibility for PIF is equity participation in quasi-government enterprises requiring substantial government support. Included in this group is the Saudi Arabian Fertilizer Co. (SAFCO), Saudi Consolidated Electric Co. (SCECO), Saudi Hotels and Resort Areas Company (SHARACO), and Saudi Public Transport Co. (SAPTCO). In addition, the Public Investment Fund is involved in financing various pan-Arab joint ventures with Gulf area governments, including various shipping and industrial joint cooperation projects.[7] In total, during the Second Five-Year Development Plan, the Public Investment Fund expended SR 24 billion, 28 percent of total specialized credit agency expenditures. (See Table 5.2.)

Table 5.2 Capital inducement, 1975–1980

Agency	*Government expenditures*	*% of total*	*Induced expend.*	*% of total*	*Inducement ratio*
PIF	24	28	4	28	17
SIDF	25	29	5	29	20
REDF	33	39	20	39	61
SAAB	3	4	1	4	33
Total	85	100	30	100	35

The Saudi Industrial Development Fund also performs an important role in encouraging private capital investment in electricity generation and various secondary industrial projects, especially the industrial estates in a number of regional economic centers, including Dammam, Jiddah, Al-Hasa, and Abha. During the Second Five-Year Development Plan (1975–1980) SIDF disbursed over SR 25 billion for electricity and light industry projects. While it is difficult to measure the productivity of SIDF electricity loans, the number of customers served by the private electric companies receiving SIDF loans increased by 71 percent during the five-year plan, from 350 000 to over 600 000. During the same period, installed electricity generation capacity increased from under 1000 megawatts to over 4500 megawatts.[8]

SIDF loans to private sector industry were designed to supplement bank loans, and while this has resulted in a drop in commercial loan ratios, it has achieved the basic desired goal. Loans to achieve industrial diversification were only SR 5.5 billion, or about 20 percent of total SIDF disbursements, but they have performed an important role in the kingdom's economic diversification

programs. Loans to basic building materials industries, such as rock crushers and cement factories, initially dominated the totals, but during the Third Five-Year Development Plan there has been an emerging emphasis on various secondary industries, including building products, metal products, plastics, chemicals, industrial gases, glass, food, beverages, furniture, and textiles.[9]

The Real Estate Development Fund (REDF) is responsible for funding a substantial portion of private sector individual and commercial housing. The bulk of the SR 33 billion in loans disbursed by the REDF during the Second Five-Year Development Plan period was for the construction of private non-commercial housing. Estimates of the impact of the approximately 140 000 REDF loans granted during the second plan period indicate that they were significant in ending the housing and rent shortage which developed during the early part of the second development plan period. Between 1977 and 1979 rental costs dropped by 30 percent, largely due to the impact of REDF loans.[10]

Performance

The performance of organizations like the specialized credit agencies is hard to evaluate for many reasons. However, the growth of induced capital from banks and private investors offers a possible analytical approach. One measure of inducement is based on the requirement that the borrower provides capital funds in direct ratio to the amount loaned. This varies for each agency. Table 5.2 shows that based on the private sector ratio requirements, the specialized credit agencies enabled the economy to generate approximately SR 115 billion in capital expenditure economic activity between 1975 and 1980. The emphasis on induced private sector expenditures was most significant in housing (REDF), the primary focal point area during the second development plan. Because the requirements for private sector housing contributions are higher than for the other sectors, it naturally contributed a larger percentage share of the total funding. This sector, however, provides the least support for long term industrial diversification and capital market development.

Because SIDF provided 100 percent of the funds required for power generation development, the only private sector investment induced by SIDF funding was effected through its loans for small scale industrial diversification. Power generation, however, is a critical variable in the diversification planning effort. Spreading from the eastern region where there already was in existence a scattered power network, SIDF funding enabled consolidation of the eastern network and then the establishment of networks in the central and western regions simultaneously, using the eastern region as a model. The capital expenditures on power must be viewed as a necessary element in the industrial diversification effort, and in raising the standard of living. These loans also have had a multiplier effect on other industrial development expenditures.

In sum, the specialized credit agencies during the second development plan period effected a big shift in development priorities and spent considerably

more than called for in the plan: SR 85 billion compared to the planned amount of SR 54 billion. As Table 5.3 indicates, the individual agencies experienced a wide variety of emphasis. Only the PIF actually committed less than planned. The other agencies spent several times more than the amount called for in the plan. Table 5.3 also considers each agency's expenditures as a percentage of the total plan, with the percentages of plan expenditures varying widely. The PIF loaned only 59 percent of the planned amount, due primarily to delays in the organization and construction of the industrial complexes at Jubail and Yanbu. SIDF disbursements were 331 percent of the planned target as a result of greater-than-planned-for investments in electricity development. The REDF expended 611 percent of its planned amount for three interrelated reasons: (1) the demand for housing and loans was greater than expected; (2) the size of the housing units constructed was larger than anticipated; and (3) construction costs increased and forced up the loan limits for private homes. Agricultural Bank loan disbursements were 600 percent of the plan target due to an underestimation of the number and size of loans that would be applied for. Overall, the funding agencies disbursed 157 percent of the second development plan target.

Table 5.3 Specialized credit agencies: results summary, 1975–1980 (SR billion)

Agency	*Planned disbursements*	*Actual disbursements*	*Plan–Disburs. ratio*
PIF	40.5	24	59%
SIDF	7.56	25	331%
REDF	5.4	33	611%
SAAB	0.5	3	600%
Other	0.04		0%
Total	approx. 54	85	157%

The most important achievement of the specialized credit agencies has been the encouragement of local investment and the creation of the first phases of a significant long-term credit development program in the kingdom. This effort could lead to the eventual expansion of the internal capital and secondary financial instruments market. While the main emphasis during the second plan was on completion of private sector infrastructure (housing, electricity, pipelines, etc.) future spending should indicate more interest in private investment in the import-competing and export-oriented industries which will provide the investment for future development of private sector finance. For this reason, the third development plan expenditure forecasts show relatively greater emphasis on the industrial development efforts of the PIF and the SIDF.

SAUDI INVESTMENT BANKING CORPORATION

An additional capital market institution, technically a commercial-type bank, is oriented towards investment rather than commercial banking. The Saudi Investment Banking Corporation (SIBC), a privately established Saudi Arabian bank, was established by royal decree in June 1976, and it is a unique organization in Saudi Arabia. SIBC's purposes are to encourage private sector economic development by providing long-term 'no interest' equity-type financing for Saudi industries, to conduct feasibility studies for proposed projects, to assist in project development, and to supplement short-term bank lending. SIBC shares are divided among three groups: the Saudi public (36 percent); the Saudi sponsors – National Commercial Bank, Riyad Bank, Bank Al-Jazira, and the General Organization for Social Insurance (29 percent); and foreign sponsors – Chase Manhattan Overseas Corporation, Industrial Bank of Japan, and J. Henry Schroder Wagg & Company (35 percent). Chase Manhattan Bank manages SIBC.[11]

SIBC performs a central role in the effort to channel the kingdom's private financial resources into industrial, commercial, and agricultural ventures. SIBC specializes in the provision of medium- and long-term finance but also provides a full range of corporate banking services including the issuance of letters of credit and guarantees, depository and investment services, foreign exchange, and cash management. In general, SIBC operations have grown at a slower rate than those of the kingdom's commercial banks. Statement results through 1982 are indicated in Table 5.4. Performance was slow in developing, with asset growth rates declining, loans outstanding actually declining, and the various ratios declining. SIBC operations provide an indication that medium- and long-term credit generation in the private sector has not yet been developed seriously.

Table 5.4 Specialized credit agencies: expenditure projection (SR billion)

	*1975–1980 actual**		*1980–1985 projected**	
	Gov.	*Priv.*	*Gov.*	*Priv.*
PIF	24	4	60	15
SIDF	25	5	46	30
REDF	33	20	55	37
SAAB	3	1	5	2
Total	85	30	166	84

Sources: Second and Third Five-Year Development Plans; Arabian–American Oil Company, Local Industrial Development Department, 'Saudi Economy in Perspective: Outlook for 1980–1985', December, 1980, pp. 7–9.

* Constant 1980 Saudi riyals.

THE SAUDI STOCK MARKET

The plans for a Saudi stock market have been in the making for several years, but due to the many development problems, the general public's relative lack of sophistication with regard to stock issuance and trading, the small potential market, and the government's concern about stock market excesses in other areas of the Gulf, there has been little sustained interest in developing a formal exchange. Various ministry officials, regional and national businessmen's groups, Chambers of Commerce groups, and bankers have supported such a move, arguing that in general a stock market would provide an important element in the generation of the private sector capital required in the next stage of economic growth. However, the unofficial stock market suffers from a number of problems which require solution before serious effort can be given to establishing an official stock market.

Then first problem is that there are three sources of official directives from the government to the stock market, and yet there is no organized legal framework for the proposed stock exchange. The three sources are the Ministry of Finance and National Economy, SAMA, and the Ministry of Commerce. Such a situation creates confusion for trading and related activities, and discourages those who might be interested in participating in an official market. Closer examination reveals that the Ministry of Finance and National Economy has issued a directive that all stock transactions should be carried out using the commercial banking system as the settling agent, while the Ministry of Commerce has prohibited the use of post-dated checks in stock transactions.[12] Finally, SAMA, which controls banking activity in the kingdom, has not commented on either directive, even though both directly affect the operations of the banks.

The second problem is that, because there is no official policy to regulate stock exchange activities, a number of non-specialist offices have emerged to deal with shares. These operations are similar to those of real estate brokers and many have made substantial profits on the sheer speculation, owing to the lack of regulation and to their knowledge of stock market operations. The unofficial brokers effectively fix the prices and are involved in unhealthy shareownership control. However, since there is no law to limit shareownership and there are no competent brokers to handle stock transactions effectively, this is an unfortunate but understandable development.

The third problem is the ownership of large percentages of the shares by members of the board of directors and the founders. The number of shares owned by this group, compared to that owned by the general public, effectively allows the directors and founders to set the market price, depending only on what the market demand will bear at any given point in time. For example, the Arab National Bank began operations as a Saudized bank in 1979 with 155 000 shareholders, but in 1982 it had only 18 000 shareholders, with five or six individuals owning approximately 130 000 shares.[13] The price of this par value SR 100 stock in May 1983, to some degree due to this key factor, was approxi-

mately SR 1120. In addition, the investors who bought shares during the issuance period avoided the existing controls on shareownership by using different Saudi names, thereby ending up with a large number of shares compared to the general public's ownership.

A fourth problem is that most Saudi citizens as yet have little understanding of stock operations and transactions. Consequently, most transactions are made without concern for the financial position or statements of the firm, its stability, or its profitability. Shares are even being traded for unissued stocks of companies that are not yet in operation. For example, the stock of the Saudi-Kuwaiti Cement Company, which has a par value of SR 100 and is not yet constructed, sold in mid-1983 at SR 385.

In addition, due to the limited number of channels of investment as a result of the slowdown in business activity and the excess cash on hand, stock speculation has increased. This factor, coupled with increasing stock prices, has encouraged the view that stockownership is always a profitable business, without consideration being given to the reasons for the increasing stock prices.

A final problem is that citizens from other Gulf countries, via Saudi agents, have invested in Saudi stocks. This not only has increased the competition for and speculation in the stock market, but it also results in riyal movements outside Saudi Arabia and a net negative exchange when dividends and stock capital gains are repatriated. This activity effectively has decreased the number of shares available for exchange.

A possible role for the government in regulating stock operations involves a number of critical steps. Clearly, the first step should be to assign to one government body responsibility for share companies. One option is the Ministry of Commerce since it is responsible for overall company activity in the kingdom. Such an action would avoid further confusion since there would be one official source of instructions and directives. A second step would be to establish an effective set of regulations for the organization of stock operations and transactions. The law must cover the requirements that should be fulfilled when establishing specialist and/or brokerage offices, and it must impose effective limits on individual shareownership. This law would also exercise control over the use of other people's names in the purchase of shares. Specific procedures should be detailed for selling and buying shares. The controlling ministry should develop the capability to monitor all share traders and brokers as well as the prices of the shares and should be the official source for the published stock prices. The most important aspect of the stock market matter is that there should be more publicly held companies in Saudi Arabia in order to increase the potential number of issues and shares. There are still only 35 companies registered in Saudi Arabia, compared with 48 in Kuwait.[14]

SAUDI INTERNATIONAL DEVELOPMENT FUNDS

The Saudi international development funds have supplied loans primarily to Islamic lesser developed countries and have performed an important economic

development role over the last few years. The major Saudi-based development bank, the Islamic Development Bank (IDB), founded in October 1975, with 42 Muslim country members at present, is designed to encourage and assist social and economic progress in developing Muslim countries. Most of the IDB assistance is in the areas of infrastructure, specialized funding, foreign trade, and technical assistance. The IDB also engages in considerable support of national currencies, encourages elimination of currency restrictions, and co-operates with the IMF by following its guidelines to establish and maintain reasonable exchange rates and free convertibility. Saudi Arabia is the largest contributor to and shareholder of the IDB, and is the host country (Jiddah is the host city), contributing $60.6 million to the $236.4 million capital base of the IDB; Saudi Arabia also acts, through SAMA, as the depository for the fund. As a Muslim development fund the IDB is bound by Shariah rules on interest and operations.

Table 5.5 Arab International Development Fund loans 1981

Rank	*Fund**	*Loans*	*Number*	*% Share*
1	KFAED	718.42	34	28
2	IDB	587.00	61	22
3	OFID	414.62	68	16
4	SFD	347.65	19	13
5	IFED	224.60	4	9
6	AFESD	149.97	15	6
7	ADFAED	99.90	9	4
8	ABEDA	70.10	8	3
Total		2 612.26	218	100

Source: Middle East Economic Survey, 22 March 1982, Finance, Banking, pp. vi/vii.
Development funds (titles):
(1) Kuwait Fund for Arab Economic Development
(2) Islamic Development Bank
(3) OPEC Fund for International Development
(4) Saudi Fund for Development
(5) Islamic Fund for Economic Development
(6) Arab Fund for Economic and Social Development
(7) Abu Dhabi Fund for Arab Economic Development
(8) Arab Bank for Economic Development in Africa

While the primary purpose of the IDB is to provide financial assistance, normally in the form of equity loans, it has been forced by economic conditions into foreign trade financing which is a consequence of the adverse balance of trade situation of most of the non-oil Islamic countries. A growing number of these countries have a severe problem in servicing the interest charges on their international loans. One-third of these countries have annual interest or debt service obligations of between 10 percent and 40 percent of their exports. To respond to this situation and other development requirements the IDB has set up a combination of trade finance, equity and lease financing arrangements.

Co-financing arrangements handle approximately 50 percent of the IDB outstanding commitments. In this effort the central banks in the various recipient countries are assisting in the financial and market studies as well as the repayment programs. Further, the central banks have been involved in encouraging further cooperation between the various member states to expand trade between them.

The IDB is funded from three main sources: (1) Capital resources and capital subscriptions, deposits and loan repayments; (2) Special fund resources and contributions, and funds from operations net income, and repayments from special fund resources; (3) Trust fund resources, which include administrative cost receipts and repayments of funds financed from trust fund resources. While these sources can provide considerable equity-oriented income over the long run, in the early development years they present less than can be obtained through the capital markets. Thus with the ebb in oil revenues which began in 1982, the IDB began to experience difficulties. While the loan commitments remained constant, and applications increased, the amount available for loans and investments diminished. Further, the decline in interest rates in the West increased the difficulty involved in supporting the IDB's long term, low interest, loan program.

The financing arrangements established by the IDB are limited by a number of factors, particularly the fact that the IDB cannot, due to the Islamic restrictions on interest payments, obtain funds from the capital markets to meet its extensive resource needs. It also faces severe stringencies due to the fact that most of its deposits are short-term, and could be terminated at any time, but its loan commitments are long-term. There is concern today that the IDB currently has committed most of its funds and still must conform to Islamic law. Thus, in dealing with 'income' earned on its deposits with SAMA and otherwise responding to the requirements for IDB assistance it has progressed significantly over the past few years. Its major problems today are similar to those of the Saudi commercial banks: a lack of direction and priority and, more importantly, a lack of expert personnel to carry out its various loan research activities.

In conclusion, in a relatively short time the kingdom's financial institutional system has evolved into one of strength, nationally and internationally. As a result, the present commercial banking money and credit system is adequate for most current internal development needs, but further banking expansion and effective money and capital market development are prerequisites for continued private sector economic growth.

CAPITAL MARKET COMPARISONS AND PROSPECTS

Comparative Considerations

The specific changes and developments which have brought Saudi Arabia closer to a modern banking system and a comprehensive financial market

appear to reflect a pattern that threads back to the development and specialization of other financial centers in the Middle East and Gulf areas, with some variations. One source example may be Bahrain where money market transactions, mainly in Saudi riyals and US dollars, have given the island its particular speciality. Likewise, Kuwait has become a long-term financing center, mainly in dinars. This section considers Kuwaiti financial system development because it may be in many ways the best comparison for potential Saudi financial system development. Despite the liquidity shortages and government curbs on the use of the dinar in international financial market activities, the Kuwaiti financial market has reached a fairly high level of sophistication and is a meaningful comparative option for Saudi Arabia.

The Saudi Arabian Monetary Agency is giving signals to the banking community which are leading to a somewhat different development pattern from those which have occurred elsewhere in the Arab Middle East. The banking sector in Saudi Arabia is developing from and through an era of decentralized internal funds flow and economic expansion, a factor which has tended to delay the effective development of a national private sector financial system. Despite this rather fundamental difference from the activity patterns and techniques of other Arab Middle East countries, comparisons between nationalization and monetization patterns in the financial systems of Saudi Arabia's Middle Eastern neighbors are valid. Further, the kingdom's transition in financial market development has been similar, with only different time frames, procedures, and organization patterns. Kuwait is chosen as an example for comparison because, due to the smaller population, a more cohesive geographical and economic base, and a different orientation regarding monetary policy, there has been substantially more development in money and capital markets.

In Kuwait, as in Saudi Arabia, foreign trade financing has until recently been the main area of money market activity. Over 70 percent of the banking activity in Kuwait is still in short-term financing of foreign trade, and the remainder is in stock market speculation or real estate development. However, because exports, primarily oil, accounted for more than twice the money value of the imports, there was clear impetus for significant money market growth from the trade surplus. In response, banking activity has increased as the government encouraged, and the private sector has placed, more emphasis on local and international banking and expansion of supporting service industries.[15]

The Central Bank of Kuwait, formed in April 1969, has the primary objective of ensuring currency stabilization through the regulation of credit and supervision of the banking system. These goals, very similar in content and philosophy to those of SAMA, point the way to the comparison between the growth of money and capital market operations in Kuwait and Saudi Arabia. The commercial and government banking systems in Kuwait are similar in form to those in Saudi Arabia, with seven commercial banks and three specialized banks (the real estate bank, the industrial development bank, and a savings and credit bank). However, there is a difference in the ownership arrangements in Kuwait. Four of the seven commercial banks are privately owned, and three

(the Bank of Kuwait, the Bank of the Middle East, and the Burgan Bank) are owned jointly by the government and private interests. The only commercial bank with any foreign interest is the Bank of Bahrain and Kuwait.[16]

Commercial investment in Kuwait has developed very much as in Saudi Arabia. Initially, domestic investment in Kuwait was achieved through public sector investment in the infrastructure. Also, as in Saudi Arabia, there was expansion beyond traditional trading activities. As the private sector diversified away from trade, the demand for longer-term finance developed. This move has been so successful that the government is in the process of ending all public sector direct financial investment in private enterprise activities. The financial markets in Kuwait consequently have been oriented towards overseas investment as well as towards local longer-term loan demand. The main factor in this process has been the recent trend away from foreign currency-denominated paper into instruments generated from within the Kuwaiti financial markets and denominated in Kuwaiti dinars.

Commencing with international bonds, denominated in dinars, interest rates in the deposit market set a floor for the cost of medium- and long-term capital. This, along with the lack until 1980–1981 of an effective secondary market in Kuwaiti dinar bonds, has been the one major developmental deterrent in the Kuwaiti financial markets.

A primary force in the development of the Kuwaiti financial system since 1973–1974 has been the two government-supported investment companies, Kuwait Investment Company and Kuwait Foreign Trade Contracting and Investment Company, and one private investment house, Kuwait International Investment Company, all of which have been very active in underwriting and managing Eurobond loans. Many of these loans, denominated in Arab convertible currencies (Kuwaiti dinars, Bahraini dinars, UAE dirhams, and Saudi riyals), have been extended to developing nations including Brazil, Mexico, Panama, the Philippines, Indonesia, Turkey, the Republic of Korea, Algeria, Gabon, Tunisia, Morocco, and Sudan. The Kuwaiti dinar bond market has been quite active in this process, handling over 54 KD-denominated international bond issues between 1974 and mid-1979. Of the total of $1.3 billion, Arab borrowers floated 12 of the issues and 26.9 percent of the total value. In addition, concessionary lending institutions, such as the Caissé Centralé de Coopération Économique, also have entered the Kuwaiti dinar development bond market. The prime advantages of the Kuwaiti dinar market have been that it is a new market which has not reached country loan limits as is true in many Western nations, the currency is relatively stable, terms are more favorable than those in dollar markets, the prices on the Kuwaiti dinar market have been stable, and the secondary market in Kuwait is strong in terms of transaction size, liquidity, and trading spread.[17]

The money market in Kuwait provides Saudi planners with a proving ground for money and capital market innovation, which greatly aids the Saudi learning process. At present, investors in Kuwait have the option of depositing Kuwaiti dinars in the banking system, investing in dinar bonds, or investing abroad. The high international interest rates have drawn a considerable portion of the available funds out of the country, thereby limiting somewhat the ability of the local banks to make loans, and as a result the local commercial banks have moved to the issuance of medium-term Kuwaiti dinar certificates of deposit. This move has had the double advantage of providing not only increased investor liquidity, with a medium-term investment outlet, but also enabling the banks to lengthen the maturity dates on their investments.[18]

Financial Market Evaluation

One of the main considerations in the evolution of the Saudi financial market system is whether there is a need and/or role for the opportunities afforded through the development of the system and the resulting financial markets. This is not an easy question to answer in the framework of Saudi Arabia's vast resource capabilities but undeveloped business economy. The question could be: What are the long-range economic goals of the kingdom and the best means of attaining these goals without conflict with political, religious, and other fundamental considerations? It cannot be assumed that economic goals will override all others, but the overall goal, economic diversification, requires consideration of the restriction on interest, the major issue in the development of the Saudi financial market system. This question has long been important, and while it remains unsettled the growth of internal financial markets will be limited.

Another consideration to the development of the financial market in Saudi Arabia is whether there is any reason why it should develop. On one hand, it is clear that recent financial market developments in Kuwait, Bahrain, and the UAE indicate a more aggressive financial market attitude in these countries. However, if these systems were transplanted to Saudi Arabia they could represent a threat to the kingdom's internal stability. For example, since 1976 and 1977 offshore banking units from Bahrain have come to Saudi Arabia to finance imports, bid bonds, and contract guarantees. They have been able to do this basically because the Saudi commercial banks could not handle the volume of business in the kingdom, and the OBU service charges were well below those authorized by SAMA because of competition and excess capital reserves. This problem still exists because of the high interest rates offered in Bahrain for Saudi riyal deposits, some of which in turn came back to Saudi Arabia in the form of business loans. However, SAMA has begun to blunt the OBU attack through bank Saudization and by lowering the charges for documentary credit services and other bank services. Both of these actions allow the local banks to compete more effectively in commercial loan activities.

In this connection, SAMA also has been forced to perform a balancing act to prevent or end any foreign control over the banking system and thus the money market. Saudization of the banking system is one means of preventing such a scenario because as the capital and credit limits on the Saudized banks are

increased more capital investment is infused into the banking system, precluding part of the advantage that the OBUs hold over the Saudi commercial banks. Many of the OBUs have loan officers in Saudi Arabia, administering loans through Bahrain to escape SAMA controls. Accordingly, as noted before, SAMA has reacted by aiding and encouraging the National Commercial Bank and Riyadh Bank to organize offices in Bahrain to stem the riyal flow.

SAMA has also attempted to maintain control of the money market in Saudi Arabia by preventing internationalization of the riyal. High international interest rates have drawn riyals out of the kingdom, and in order to maintain liquidity in the domestic system SAMA has been forced consistently to inject new riyal currency to prevent money shortages and consequent interest rate increases which would add to the inflation in the kingdom. However, the attempts to control the flow of riyals out of the kingdom have killed bankers' efforts to sell foreign bonds in Saudi Arabia, and the denomination of large government contracts in dollars, rather than riyals, has not only effectively limited the foreign demand for riyals but also assured the OBU bankers of a key role in the Saudi financial market for years to come.

Despite some apparent development problems in the banking system, Saudi Arabia presents a potentially strong money and capital market due to the favorable disparity between revenues and Gross Domestic Product (GDP) development. Viewing revenues as the driving force behind the economy, and GDP as an indication of the use of the revenues, it is apparent that the growth process has barely begun.

Another key indicator in the assessment of monetary and financial market system development is the growth in foreign assets. There has been an increase in this activity for a number of reasons, but two major considerations are the foreign exchange required to support the purchase of imports to Saudi Arabia and the desire to take advantage of interest-rate and growth opportunities overseas. In addition, the take-off in Saudi and Arab international banking operations since 1979 has been important for the overall growth of the financial system despite some problems. Even though there has been a lack of banking expertise and qualified personnel in the international banking operations, the situation is rapidly improving. Central bank restraints on the Saudi banks seeking to move offshore have been significant, but now the increase in international liquidity is making possible much more offshore development. Among the Saudi international banks are the Saudi International Banking Corporation and the Saudi Banking Corporation, both of which work with and against the Arab Banking Corporation and other Middle Eastern banking groups to form syndications for large international loans. The depth and breadth of the Saudi international banks is growing rapidly, with most of them now operating out of several overseas offices, and although their main activities are still in foreign exchange and current accounts, they are beginning to move into a broader base of banking activity.

Given the highly personal nature of the commercial banking process in Saudi Arabia and the current lack of effective organization in the banking and financial system, it is no wonder that there is a slow progression towards the perceived goals for the system. The commercial banks face the problem that a man's word may be the only collateral for loans of up to and sometimes beyond SR 100 million. However, the policy applies usually only to the biggest and best creditors. Furthermore, the change to the use of audited balance sheets, cash flow statements, and income statements is gradually improving the credit analysis process. Businessmen are becoming more and more aware of the need for greater impersonalization in the credit system as the size of transactions moves up, and the economy goes through a major revolution. As the levels of banking expertise, credit analysis, and banking technology improve, some of the blocks to financial market development will fall by the wayside. The presence of a new generation of university-trained Saudi bankers and the introduction of new training programs are having a salutary effect on credit requirements and bank operations generally.

Another positive factor in the banking and credit structure is the decentralization of the banking system. The influence of major trading families on the development of banks has delayed full economic integration in the kingdom due to the political and historical importance of the banking and business establishments in the Western and Central Provinces. But, with Saudization of the banking system, the presence of a highly trained banking leadership, the growing industrial importance of the eastern region, and the economic links being created between all the regions, this factor will diminish in importance.

In the Middle East today, especially in the capital-exporting nations, there is a move towards establishing services that customers need in preparation for achieving meaningful regional and national economic growth. The establishment of underwriting houses to create financial arrangements for private and public sector projects and brokerage firms to provide for a smooth flow and functioning of the money stock, as well as the creation of bond markets to use debt as a lever in the growth of industry and the economy generally, are necessary. There is also a need for trust companies and trust functions in the commercial banks to provide private customers with the depository services necessary to facilitate settlements in the secondary markets.

To make all of this possible it is essential to have the overall supportive legal framework required to define the nature and interpretation of commercial contracts collateral and property ownership forms and rights. In conjunction with this process there is a need for a business-oriented court system to settle justly and without undue delay problems and differences between lenders and borrowers. As the banking and legal systems become more sophisticated, the flow of private funds through the financial and money market system will grow to sustain lasting and long-term economic development.

Another major question, based on recent banking development, is whether Saudi Arabia can and/or will be able to develop a financial market like those already established in Kuwait and Bahrain and what shape this market would take. Clearly, among the major variables are government policy developments and public opinion. Government policies, rarely are made clear to the users in

advance, and government intentions/plans generally are not fully carried out. Public opinion, along with directives from religious authorities, can always have an impact on any government plans and policy directives. These conditions provide a major unknown which can and will affect the stability of any financial market development.

In order for any financial market to develop there must be a number of intangible economic growth elements present, but among the specific criteria are:

(1) a significant local level of bank lending and financing activity;
(2) an active trade in stock issues and other transferable securities;
(3) government borrowing and lending activity between the central bank and the merchant and commercial banks.

In Saudi Arabia the first condition is not yet established since the majority of lending and financing in the kingdom is made available interest-free through the government funding agencies since the banks are still unable to handle the required quantity of loans. Further, Saudi banks could not loan at an interest charge because of the religious and social pressures, nor would they freely choose to absorb losses on interest-free loans when the alternative is to place their excess funds at a high interest return in the West.

The second prerequisite for a financial market, active trade in stock issues and other transferable securities, is slowly emerging. Bank and selected industry shares are being actively traded, with 'dealers' acting as middlemen rather like the real estate dealers. The stock shares 'dealers' earn commissions (fees) from both the seller and buyer in some instances, or from the seller only in others. The fee is usually about 2½ percent of the value of the transaction. Despite its potential, this system is unlikely to develop even remotely like those in Europe or the USA for many years to come for two main reasons:

(1) the stock market will remain small due to the number of banks and commercial institutions that could be absorbed in the economy;
(2) there is a complete lack of suitably trained Saudis or other Arab professionals in the field.

In addition to these reasons another constraint in the development of the stock market is the variety of securities that will be offered for trading. It would be very unlikely that bonds and notes would be traded in any Saudi market due to the interest-bearing feature of these securities.

The third precondition for the emergence of a financial market similar to those in Kuwait or Bahrain, government borrowing and lending activity between the central bank and other banks, is unlikely to occur because of two major factors:

(1) the Saudi government should not need such funding for a number of years;
(2) SAMA cannot, by charter, lend or borrow money.

However, SAMA could provide support for one of the commercial banks once

it has sufficiently expanded its internal activities through investments, etc. The situation probably would never develop as it has in other developing countries, again because the system could not be interest-oriented.

Thus, the most that could occur in the near to mid-term future is a money market based on share trading or possibly profit-sharing debentures or, more correctly, redeemable preference shares, in which speculation rather than interest will be the main force behind the trading in the market. This would be a very basic trading system rather than a sophisticated one.

DISCUSSION QUESTIONS

5.1 Describe the various stages of financial market development in the Arab Middle East and Saudi Arabia.
5.2 Identify some of the factors in the generation of loanable funds in Saudi Arabia.
5.3 What is the basis for some recent money market developments in Saudi Arabia? Assess the impact of these developments on the Saudi economy.
5.4 What is meant by the 'financial market process' in Saudi Arabia?
5.5 Describe the capital market intermediation process in Saudi Arabia.
5.6 What are the roles and purposes of the Saudi specialized credit agencies?
5.7 Discuss the growth and results of operations of the Saudi specialized credit agencies.
5.8 Describe the purpose of the Saudi Investment Banking Corporation.
5.9 What are the main problems in the development of the Saudi stock market?
5.10 Discuss the purpose and the accomplishments of the Saudi international development funds.
5.11 Compare the Kuwaiti and Saudi capital market activities and prospects.
5.12 What are the prerequisites for financial market growth and development in Saudi Arabia?
5.13 Is it reasonable to expect the emergence of a mature capital market in Saudi Arabia in the near future? Discuss.

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PART III
ISLAMIC BANKS

CHAPTER 6

The Evolution of Islamic Banking

INTRODUCTION

Economic growth in the kingdom of Saudi Arabia has effected numerous changes in the financial system. These changes are defined not only in terms of increases in financial activity and institutions but also in the development of new techniques, agencies, monetary tools, financial centers, regional and international markets, offshore markets, and other new developments discussed in previous chapters. There is no doubt that the increase in Saudi national wealth has had an impact on financial centers in the Middle East, particularly in the Gulf area, as well as in other developing areas of the world. The Saudi financial system itself has been in turn affected by international and regional financial developments.

One development which merits discussion and comparison with the Saudi financial system is Islamic banking. The reason for this is twofold: first, the kingdom's historical and present identification with Islam; and second, the support given by Saudi Arabia to the existing Islamic banks and to the International Association of Islamic Banks.

In this chapter, the most distinguishing aspect of Islamic banking, the prohibition on receiving or paying interest, is presented first, followed by the theoretical and organizational developments of Islamic banks and their relationships to the Saudi financial system.

ISLAMIC VIEWS ON INTEREST

The concept of interest and its role in the Saudi financial system was introduced in the previous chapters. It is reiterated here that interest presents a major obstacle to effective financial integration and cooperation between Western and Islamic systems. Since the prohibition on interest is a dominant and basic principle applied to all operations of Islamic banks, the Islamic views of interest are presented in more detail.

The fourth edition of the *Oxford Dictionary* defines 'interest' as 'money paid for use of money lent or for forbearance of debt', whereas the eighth edition of

the *Merriam-Webster Dictionary* defines it as 'a charge for borrowed money that is generally a percentage of the amount borrowed: the return received by capital on its investment'. 'Usury' is defined by these dictionaries as an excessive rate or amount of interest, or a higher interest than is allowed by law.[7] The equivalent of 'usury' in Islam is *riba*, which has been interpreted by many Muslim scholars to mean any payment imposed in excess of repayment of the principal of the loan. It also includes, as a corollary, the excess in quantity in the barter exchange of the same commodity.[1] According to Islamic jurisprudence, such a transaction is forbidden even though there might be certain differences in the quality.[2]

Muslim scholars contend that the Holy Qur'an clearly states that at the maturity of a loan the lender is permitted to receive only his principal, without any addition. Islam has stood firm on this issue, and the Qur'an has forcefully prohibited interest. In order to appreciate fully the Islamic view of interest and to probe into the reasons for its prohibition, it is essential to discuss three related issues: (1) the distinction between interest and commercial gain; (2) the difference between consumption loans and production loans; and (3) the responsibility of the Islamic state in the absence of interest.

Interest and Commercial Gain

The Qur'an has laid down rather rigid commands with regard to interest on money. Interest, simple or compound, is forbidden regardless of the nature of the transaction involved. The argument of Islam centers around the notion that the guaranteed or secured return on the capital in the form of interest is inequitable because the contributor of the invested capital does not share any possible losses incurred. In this regard Islam profoundly objects to interest, making a very clear distinction between business gains and interest on loaned money. The Qur'an explicitly and emphatically prohibits interest and distinguishes it from gains on trade, as stated in the following verse:

> Those who devour usury will not stand except as stands one whom the Evil One by his touch has driven to madness. That is because they say: 'Trade is like usury, but Allah hath permitted trade and forbidden usury. Those who, after receiving direction from their Lord, desist, shall be pardoned for the past; their case is for Allah [to judge]; but those who repeat [the offence] are companions of the fire: They will abide therein [for ever]. Allah will deprive Usury of all blessing, but will give increase for deeds of charity for He loves not creatures ungrateful and wicked.[1]

The eternal fire penalty for the usurer in Islam is severe, but traders are blessed because the seller offers the buyer his commodity in which he invested his labor and his capital; and gains derived from such a transaction are permitted because they are the result of risk and effort. In addition, the seller

recognizes a one-time gain from the transaction, because once the exchange has taken place the transaction is over, whereas in the case of a money loan the creditor does not cease to demand interest as long as the principal is not returned. Furthermore, the amount of interest owed keeps on climbing with the passage of time, and if interest is compounded it will be the source of gain to the lender on top of his basic gain from the loan. The usurer also obtains the additional amount in exchange for the extension of time, but 'time' is neither a commodity of exchange nor exchangeable wealth. In addition, in the case of trade there is the possibility of losing, while in the case of usury, given normal economic conditions, there is an assured and continuous gain.

In this regard industry, trade, agriculture, professional services, and even arts and crafts, are factors that stand out in the process of the advancement of civilizations. They all require certain skills, personal labor, and even hardship. The usurer does not necessarily exert skills or suffer hardships, and his gain from lending money is fixed and known ahead of time. The lender shares the fruits of labor and hardship without exerting any effort and without additional liability in case of loss. A. Yusuf Ali, the widely known Islamic scholar, elaborated on this subject in his English translation of the Qur'an. He stated that usury is condemned and prohibited in the strongest possible terms and that there can be no question about the prohibition. Ali added that there is room for differences of opinion in the definition of usury. Further, he acknowledged that Muslim scholars, ancient and modern, have worked out a great body of literature on usury, based mainly on the economic conditions as they existed during the rise of Islam. He agreed with these scholars on the main principles, but not on the definition of usury. In essence, his definition of usury would include profiteering of all kinds, but would exclude extension of business credit, the creature of modern banking and finance. His agreement with the Muslim scholars centers around the principle that whereas legitimate trade or industry increases the prosperity and stability of men and nations, a dependence on usury would encourage exploitation and inhibit economic and social development. He also confirmed that the sharp contrast between legitimate trade and usury supports his definition of usury.[4]

Consumption Versus Production Loans

Islam prohibits interest on money lending without differentiating between consumption loans and production loans. On this issue Muslim scholars and advocates of Islamic economic thought differ tremendously. The prohibition of interest and the distinction between the two types of loan are in reality merely the reflections of the basic question of whether Muslims should accept the system of banking with interest or replace it with an Islamic system. Discussions related to this question point up the political views of the discussants, especially on issues related to the post office savings system and the nationalization of commercial banks. The argument has been that interest should be prohibited in the case of consumption loans and permitted in the case of

production loans. Muslim scholars who are advocates of this argument reason that consumption loans constitute exploitation of the needy and contradict the spirit of Islam, while production loans entail a collaboration between lender and borrower to increase the utility of wealth, and they should share that increase. Moreover, in the case of production loans the lender (the saver) is considered to be the economically weaker party while the borrower is considered the stronger. In the case of consumption loans, however, the role of the borrowers and savers is considered to be reversed.[5]

Contemporary Muslim scholars, such as Ahmad Shalaby, argue in favor of permitting interest on production loans because the rate of charges on loans made by specialized government funds or banks such as the agriculture banks, industrial banks, and real estate banks is not *riba*. These scholars are very explicit in permitting dealings with these banks on the basis of facilitating the process of development, growth, human advancement, and welfare. They reason that as long as the charges on the loan merely cover the expenses of managing the operations of the bank and administering the loans, these charges are not *riba*. The charges are often referred to as profit and considered to be profit sharing which is permitted by Islam.[6] Profit sharing is considered an Islamic alternative to interest and its nature and application in Islamic banking are discussed in the following chapter.

The preceding argument is rejected by other Muslim scholars who believe that any predetermined and fixed-return charges on loans are excess charges which are interest. They reject charging interest on both consumption and production loans. The rationale of the rejection of interest on consumption loans is based on human considerations because these loans are taken by people of moderate means who lack savings to satisfy certain urgent personal requirements. The rationale of the prohibition of interest on production loans is rooted in the concept of justice, as it is supposed to apply to all parties in the financial transaction. Uncertainty is a natural state of the business enterprise; its operating results cannot be foreseen, and therefore the occurrence of profit or loss and their magnitudes cannot and should not be determined in advance. As a result, it is unjust for the lender to be guaranteed a fixed and predetermined return while the party backing the production project (management, labor, and other enterprise requirements) is made to bear the uncertainty alone. They add that a fixed interest rate can also be unjust to the lender of money when the entrepreneur using this money earns a profit quite out of proportion to what he pays by way of interest.[7] This reasoning leads to the prohibition of the concept of leverage, or trading on the equity, in the field of finance.

The prohibition on interest, whether on consumption or production loans, should not be considered as a separate part of the economic systems prevailing in the Muslim countries. It is based on Islamic philosophy rather than simply a moral injunction which may or may not fit in with the present circumstances.[8] Since Muslim scholars feel that Islam is a comprehensive system designed by God for the organization of human life in all its aspects, the interest argument

needs to be resolved in the light of the economic and social welfare of the Muslim people. The experience gained from Islamic banking in the areas of consumption and production loans and other methods of financing would provide a valuable input to the argument.

The Responsibility of the Islamic State in the Absence of Interest

The strict Islamic prohibition on interest on loans places heavy social and economic responsibility on the state. It also assumes that the basic Islamic philosophy with its appeal to the goodness of human nature and its statement of the heavenly rewards and penalties for human behavior will lead to the solution of the problem of satisfying the needs of the poor and the needy.

The Islamic state has in the past developed and utilized sophisticated financial systems and institutions to oversee the welfare of all citizens, rich or poor. Islamic scholars, including Imam Al-Razi, have explained that *riba* is the cause of immorality and other social and economic ills. Interest is immoral because it breaks the bonds of natural relations between human beings; and as long as a condition attached to a loan to the needy is the payment of *riba*, it leads to inequality between the lender and the borrower. In addition, it places additional hardship on the borrower, and causes the lender to become cruel and merciless. *Riba* unjustly enables the rich to continue to dominate the poor and needy. As a result, animosity builds up between the social classes and inevitably leads to social unrest.[9]

The injunction on the Muslim lender to have mercy and help the needy debtor is to be considered with the Day of Judgment in mind, as stated in the Holy Qur'an:

> O ye who believe! fear Allah, and give up what remains of your demand for usury, if ye are indeed believers. If ye do it not, take notice of war from Allah and His Apostle: But if ye turn back, ye shall have your capital sums: Deal not unjustly and ye shall not be dealt with unjustly. If the debtor is in a difficulty, grant him time till it is easy for him to repay. But if you remit it by way of charity that is best for you if you only knew. And fear the Day when ye shall be brought back to Allah. Then shall every soul be paid what is earned, and none shall be dealt with unjustly.[10]

Even though the prohibition is clear and definite, the borrower, if he was forced by compelling circumstances to borrow with a promise to pay interest, has to repay his debt with interest as soon as possible. He is not considered wicked or disobedient to Islamic principles if he borrowed because he was in need of the loan, for basic necessities, and repays the debt when able without any delay.[11] The social impact is grave when the needy fails to pay his debt and tries to get an extension or beg for release. If his religious conviction is weak, he may cheat, steal, accept bribes, or embezzle in order to pay his debt.

The impact of interest on those who are in need of funds for urgent personal and social purposes is no doubt serious, and the satisfaction of this need requires sacrifice and integrity on the part of the lender. The solution of this problem, however, was never left to individuals alone. The role of the Islamic state, with all its available means, including the Zakat (religious tax), is of paramount importance in finding a remedy for the socio-economic problems.

Mutual sharing of wealth between people is a very basic principle of Islam. Those who have are urged to transfer a part of their income to those who have not. Zakat and Sadakat (charity) are the media of such transfer. Zakat is a compulsory levy and Sadakat is a voluntary charitable contribution. According to one Islamic scholar, Zakat literally means purification, and its work covers the moral, the economic, and the social spheres. Zakat washes away the greed and acquisitiveness of the wealthy, makes them alive to and responsible for solving the problem of poverty. The wealthy are made responsible through the state to ensure that the basic necessities of life are supplied to all the members of society. Zakat accordingly purifies wealth itself of its evil tendency to gather more and more in fewer hands on account of unequal opportunities. The rate of the Zakat tax is 2.5 percent of the net worth; however, on certain items it runs higher: up to 20 percent in the case of income derived from mining and treasure-troves.

The Zakat tax may be spent on certain categories specified by the Qur'an as follows:

> Alms are for the poor And the needy; and those employed to administer the [funds]; For those whose hearts Have been [recently] reconciled [to Truth] for those in bondage And in debt; in the Case of Allah; and for the Wayfarer; [Thus is it] ordained by Allah, and Allah is Full of Knowledge and Wisdom.[12]

In the above verse 'alms' refers to Zakat because alms are ordained by God, and compulsory charity is Zakat, as agreed upon by all jurists of Islam.

In brief, Zakat funds can be spent on two categories of individuals: first, on those who have need for the funds such as the poor, the indigent, the slaves, the debtors who incurred the debt for their own needs, and the wayfarers; and second, on administrators of the Zakat fund, persons whose hearts need reconciliation, debtors who incurred the debts for the benefit of others, and for those who work for the cause of Allah. The objectives of Zakat are many, and all can be related to social causes as well as to economic growth and development.

The institution of Zakat, then, bears a definite relationship to the concept of interest. Those who incurred debt out of need and cannot pay it can be helped from the Zakat fund. Credit for productive activities, long and short term, is a major monetary function of the Zakat fund. Such loans are to be made free of interest and according to certain criteria that set the terms of the loans, the percentage requirement of financing by the borrower himself, the eligibility

requirement for credit, and the ceiling on aggregate credit.[13] The state may make these loans free of charge for economic reasons where the beneficiaries are helped to start a new profession and achieve a higher standard of living. A loan of this kind is referred to as Kard Al-Hasan, a 'loan out of goodness', which does not give the state any direct or indirect material benefits. These loans are also given by the state for social, religious, and moral purposes, all free of charge. Private individuals and financial institutions may also grant these loans for the same purposes. However, in the case of the state it is the responsibility of the authorities to grant them out of the Zakat money which is instituted for this purpose.

THEORETICAL AND ORGANIZATIONAL DEVELOPMENT OF ISLAMIC BANKING

Historical Framework

The history of modern Islamic banks originated in 1963, when the Mitr-Ghams Savings Bank project commenced operations in a peasant town in the heart of the Nile Delta. The main purpose of the experiment was to attract the untapped savings of low-income peasants and laborers and to mobilize them for developmental investment. Within 3 years, 1000 founding depositors had been joined by 59 000 more. The bank opened four branches and four more Islamic banks began operations in the provinces during the same period. The carefully selected staff of these banks quietly built up the confidence of the community which in turn came to deposit and borrow, often repaying from profits generated by the loans; perhaps to replace a house, buy a horse, or provide a textile weaver with new supplies. The community basis of the banks was stressed, and depositors and investors identified with their money's work.[7]

The idea of savings banks was given a push when the Egyptian government issued Decree No. 967, dated March 1964, introducing savings banks to the banking system. The success of the Egyptian experience in Islamic banking was short-lived because of the lack of government support. However, the experiment was revived in the early 1970s, when Egypt and Pakistan proposed the establishment of Islamic banking during the second meeting of the foreign ministers of Islamic countries. The proposal was studied and later on led to the establishment of the Islamic Development Bank (IDB).

During the 1970s several Islamic banks were established in various Arab countries. The first Islamic bank was established in 1972 by the government of Egypt and named Nasser Social Bank. Also in 1972 Egypt invited representatives of the Islamic countries to discuss the study of Islamic banking. Late in 1972, the Ministers of Foreign Affairs of the Islamic countries were invited to Jiddah, Saudi Arabia, where a special committee was formed to prepare the joint Islamic bank agreement. In 1973 and 1974 the Ministers of Finance of the Islamic countries held two meetings in Jiddah that led to the announcement and approval of the Articles of Agreement of the Islamic Development Bank.

In 1975, the by-laws of the IDB were approved by the Board of Governors, and the Board of Executive Directors was elected, along with the president of the bank. In the same year the first private Islamic bank, Dubai Islamic Bank, was established as a public shareholding company offering traditional banking services in accordance with Islamic laws. In 1977, three banks were established as public shareholding companies, the Kuwait Finance House, the Faisal Islamic Bank of Egypt, and the Faisal Islamic Bank of Sudan. In the same year, the International Association of Islamic Banks was established with headquarters in Jiddah, Saudi Arabia. In 1978 the Jordan Islamic Bank for Finance and Investment was established as a public shareholding company. In 1979, the Bahrain Islamic Bank and the Islamic Investment Company of the United Arab Emirates were established as public shareholding companies.

In the 1970s and early 1980s several Islamic banks and investment companies were established in Pakistan, Iran, and some European countries. The largest and most internationally active bank was Dar Al-Maal Al-Islami (DMI), established in 1981 in the Bahamas with headquarters in Geneva. The authorized capital of DMI was US$1 billion allocated to subsidiary companies divided into four groups: the investment group, the solidarity group, the banking group, and the business group. In 1982, DMI bought out the Islamic Investment Company and expanded its operations to offshore banking by establishing the Faisal Islamic Bank in Bahrain. By the end of 1983, DMI expects to establish 28 banks, 9 investment companies, and 5 insurance firms worldwide.[15]

These developments reflected the desire of Muslims to deal with financial institutions with methods of operation which conform to their basic religious belief. Compliance with the prohibition on interest and other business practices that are in conflict with Shariah, such as gambling, extortion, monopoly, and hoarding, is of paramount importance to Muslim savers and investors. For this reason, smaller savers of the Muslim world have flocked to the doors of the Islamic banks that have opened in the Arab world, Africa, and Asia. In Sudan, the Faisal Islamic Bank took in US$ 10 million in deposits on its first day of operation. Its sister organization, the Faisal Islamic Bank of Egypt, reported similar progress when it was opened in 1977. Deposits at the Kuwait Finance House (KFH) have doubled almost every year since it opened in 1977. In 1981 more than 40 000 Muslims entrusted KFH with funds worth 295 million Kuwaiti dinars, about $1 billion in all.[16] This amount jumped in 1982 to KD 473 million, about $1.6 billion. When it is remembered that none of these accounts pays the saver any interest, nor comes guaranteed against loss, the phenomenal growth rate seems even more impressive. This success in attracting untapped savings reflects strong demand for legitimate Islamic investment. The acceptance of Islamic banks as media for savings, investment, and banking services, and faith in their profitability and stability of operations, led to their increased capitalization and number.

The Islamic banks established in the 1970s and early 1980s (see Table 6.1) have unique characteristics, a different ownership structure, and multiple objectives that set them apart from the Western-style conventional banks.

Table 6.1 Islamic banks: location, year established, and authorized capital

Name of institution	*Location of headquarters*	*Year established*	*Authorized capital as of 31.12.1982* *(millions)*	*(millions US$*)*
Nasser Social Bank	Cairo, Egypt	1972	EP 20†	28.57
Dubai Islamic Bank	Dubai, UAE	1975	DH 50†	13.6
Islamic Development Bank	Jiddah, Saudi Arabia	1975	ID 2000	2146.46
Kuwait Finance House	Kuwait	1977	KD 15†	51.2
Faisal Islamic Bank of Egypt	Cairo, Egypt	1977	$40	40.0
Faisal Islamic Bank of Sudan	Khartoum, Sudan	1977	SP 50	55.5
Jordan Islamic Bank	Amman, Jordan	1978	JD 4†	11.1
Bahrain Islamic Bank	Manama, Bahrain	1979	BD 23	61.2
Dar Al-Maal Al-Islami	Geneva, Switzerland	1981‡	$1000	1000.0

* Official exchange rates quoted from *IMF International Financial Statistics*, **XXXV** (12), December 1982.
† Paid up in full.
‡ Formed July 27, 1981 as a trust under the Laws of Commonwealth of the Bahamas.

Some of the Islamic banks were established for social objectives, such as the Nasser Social Bank of Egypt, but others such as the Islamic Development Bank were concerned with economic development and promotion of trade between the Islamic countries. Still others were to be multipurpose banks offering a wide range of banking services with emphasis on investment, such as the Dubai Islamic Bank, the Kuwait Finance House, the Bahrain Islamic Bank, and Dar Al-Maal Al-Islami. The Islamic banks are either owned solely by one government, such as the Nasser Social Bank, or by many governments such as the Islamic Development Bank. The rest of these banks are owned by private individuals, other Islamic banks, and/or governments. All Islamic banks share an acceptance of the Islamic law regarding the prohibition on receiving or paying a fixed rate of interest. They all share in the risks involved in business operations and, consequently, in the profit and loss.

According to advocates of Islamic banking, the Islamic ideology concerning banking operations may not be appreciated by outsiders. Ahmad El-Nagar, secretary general of the International Association of Islamic Banks (IAIB), once defended Islamic banking ideology by saying, 'People misunderstand us,

we are not fanatics. On the contrary, we seek to integrate the Islamic masses in the capital formation process with modern means for the sake of quick, strong and healthy social and economic progress.' Islamic banks adhere to the Islamic Shariah. Almost all of them have Shariah supervisory boards or Shariah consultants who approve their method of operations and certify to this effect their annual reports in order to keep the bank activities in line with the Shariah.

The increases in number and capital of the Islamic banks are the result of their acceptance by the people and governments of several Islamic nations. However, the need for establishing a technical advisory body was realized early in the growth of the movement of Islamic banks. In 1977 the IAIB was established. The practical reasons for its formation were:

(1) The growing number of Islamic banks organized by issuance of government decrees and laws, mainly in the Islamic countries;
(2) The need for technical aid to support a relatively new concept of banking;
(3) The need for planning and control of Islamic banking activities, particularly during the period of natural growth of the Islamic banking movement;
(4) The need to protect the Islamic banking movement from any thoughts or practices that are not in conformity with Islamic principles;
(5) The necessity for undertaking research and studies in the field of Islamic banking, particularly in areas that cannot be handled by one bank alone;
(6) Training the needed personnel of the existing and future banks;
(7) Unifying the practices of the Islamic banking system to conform with the Shariah.[17]

The objective of the IAIB is to strengthen relations among Islamic banks, paving the way for cooperation between them, coordinating their activities and ensuring their Islamic identity. The IAIB aims at implementing the rules and systems governing business and economic transactions in the Islamic society.

The achievements of the IAIB include:

(1) Participation in establishing several Islamic banks such as Faisal Islamic Bank of Sudan, Faisal Islamic Bank of Egypt, and Bahrain Islamic Bank and preparation of studies for the establishment of Faisal Islamic Bank in Jordan, specialized Islamic Banks in Pakistan, and Qatar Islamic Bank;
(2) Providing technical consultation and studying the measures and activities undertaken by the Islamic banks. The Association gives priority to following up on the operations of these banks in order to maintain their Islamic and operational principles and insure their success;
(3) Cooperation in an advisory capacity to establish new banks in

Mauritania, Malaysia, Nigeria, Iran, Lebanon, Europe, and America;

(4) Selection and placement of the necessary manpower needed for implementing Islamic bank operations and for educating and training bank personnel. An International Institution of Banks and Islamic economies is in the process of formation with the cooperation of several Islamic universities;

(5) Spreading the call for Islamic economies by (a) attracting the attention to Islamic economic thought through publication of books, pamphlets, and magazines; (b) unifying Islamic Banks' system of organization and control by issuance of the Scientific and Practical Encyclopedia of Islamic Banks; (c) formulating economic theory in Islam through public lectures, discussions, and encouragement of research; (d) participating in planning programs, methods of teaching, and textbooks needed for Islamic economic studies and the Islamic Banks' diploma course in three universities located in Sudan, Saudi Arabia, and Egypt; and (e) participating in Islamic International Scientific Conferences, the latest of which was held in Islamabad in March 1981.[18]

The IAIB has twelve member banks and is backed by the Organization for Islamic Conference (OIC) with semi-official status stemming from OIC foreign ministerial resolutions specifying it as a key element in the Islamic banking and economic movement. The IAIB is firmly supported by Saudi Arabia's Prince Muhammad Al-Faisal Al-Saud, its president, who is very active in the Islamic economics movement and who is a staunch believer in the role of Islamic banking in spurring social and economic development of the developing countries, especially the Muslim countries.

Philosophical Framework

The philosophical framework embodies the basic objectives and the innate aspects of Islamic banking. It is attempted here to answer some very basic questions:

- What is the definition of 'Islamic bank'?
- What are the general and specific objectives of Islamic banking?
- What aspects differentiate the Islamic banks from other banks?

Islamic Banking Defined

In a recent meeting of the IAIB, aimed at studying the managerial and organizational aspects of Islamic banking, the discussants agreed on the following definition of an Islamic bank:

> The Islamic Bank is a banking establishment that solicits funds and

> employs them in accordance with the Islamic Shariah, for the purpose of building Islamic solidarity and insuring justice of distribution and employment of funds in accordance with the Islamic principles.[18]

Islamic banking literature reveals several definitions of Islamic banks, but it is sufficient to elaborate on the above, which emphasizes the aim of an Islamic bank to accomplish the following:

(1) Attracting and soliciting funds, employing the resources available in the Islamic countries, and developing the saving habit among individuals;
(2) Directing the available funds to investment in projects that serve the objectives of economic and social development in the Muslim countries;
(3) Offering banking services, according to Islamic Shariah, free of interest and extortion and aiming at solving the problem of short-term financing.[20]

Objectives of Islamic Banking

The publications of the IAIB state the general objectives of Islamic banking, such as the conformance to Shariah, linkage of economic development to social development, encouragement of charitable contributions, and the prohibition on receiving or paying interest with the intention of preventing its bad effects from occurring and ensuring justice to all parties involved in financial transactions. However, the Articles of Agreement of the established Islamic banks are more explicit and specific about their objectives. Their basic objectives are not different from the general objectives set by the IAIB's. For example, the purpose of the Islamic Development Bank is to 'foster economic development and social progress of member countries and Muslim communities individually as well as jointly in accordance with the principles of the Shariah'.[21] The objectives of the Faisal Islamic Bank of Sudan are similar to those of the IDB, but are stated more explicitly: 'In conformity with Rules of Islam, the Bank endeavours to stimulate social and economic development through the performance of all banking services, financial transactions, commercial operations and all other investment activities.'[22]

The Jordan Islamic Bank and the Kuwait Finance House emphasize in their objectives the fact that their operations, services, and investment are performed without practising usury. Moreover, providing funds to sectors which are not likely to benefit from conventional banking facilities is one of their stated objectives.[23] In addition to the emphasis on offering banking services, such as those offered by commercial, industrial, agricultural, co-operative, and real estate banks, the objectives of the Bahrain Islamic Bank include participation in profits, loans, deposits, and guarantees activities approved by law for investment and insurance companies on the basis of Islamic Shariah.[24]

Most Islamic banks include in their objectives the establishment of subsidiaries or affiliated companies and ownership participation and/or cooperation with other financial institutions with similar objectives. Recently one of those banks, Dar Al-Maal Al-Islami, was organized for the purpose of conducting diversified financial business through the establishment and acquisition of operating subsidiaries. This bank was created with broad religious, social, and economic goals. More specifically it aims to:

1. remove the burden of the sin of Riba from Ummat Al-Islam [Islamic Nation];
2. promote economic unity among Muslim States;
3. promote Islamic religious, political and cultural unity through economic unity and shared Islamic financial institutions;
4. assist Muslims in the development of their commercial and industrial potential; and
5. provide an indigenous Islamic basis for full economic cooperation with the non-Muslim 'people of the book' in conformity with the precepts of the Holy Quran.[25]

Note that the emphasis in these objectives is placed on Islamic unity, diversified operations, and the cooperation with the 'people of the book' (Christians and Jews) in the hope of having Islamic communities everywhere conform to Islamic Shariah.

Aspects of Islamic Banking

It may be inferred from the objectives of Islamic banks that an Islamic bank is a financial, investment, development, and social institution that follows Islamic principles in all its operations. The aspects that differentiate the Islamic banks from other banks are found in five key areas: (1) ideological, (2) developmental, (3) investment, (4) positive attitude, and (5) social.

The ideological aspect Islamic banking derives its logic and beliefs from Islamic Shariah. In order to assure compliance with the Islamic philosophy and principles most Islamic banks have an external supervisory body which certifies that the operations and services of the bank are in conformity with these principles. For this reason basic knowledge of the Islamic ideology is essential. The principles of Islam form an integrated framework that unifies human beings socially, politically, economically, and spiritually. Islam is unique because its principles encompass the needs of man and the practical aspects of fulfilling them in a most comprehensive, perfect, and balanced manner. The basic values of Islam which form the profound philosophy of the religion are (1) justice, (2) moderation, and (3) mercy.

According to the Holy Qur'an, justice has to prevail in Muslim society in spite of the differences in philosophy, religion, and social and economic status of the people who live in that society. Moderation relates to all the daily issues

and affairs that prevent the Muslim from going to extremes. The Qur'anic call to the Muslims for moderation and balance concerns 'those who, when they spend, are not extravagant and not niggardly, but hold a just (balance) between two extremes'.[26] This principle stops a person from exceeding the limits set by Allah so that he will neither cut short his duties towards Allah nor exceed them.

Mercy carries the elements of forgiveness. Allah asked the Prophet Muhammad to convey this message to the believers: 'When those come to thee who believe in Our signs say: "Peace be on you: Your Lord had inscribed for Himself [the rule of] mercy: verily, if any of you did evil in ignorance and thereafter repented and amended [His Conduct], lo! He is Oft-Forgiving, Most Merciful."' [27] Mercy gives the Muslim a psychological satisfaction because he knows that his consciousness of himself as a merciful human being comes from the Most merciful and Ever-forgiving Allah.

The ideology of Islamic banks derives its principles and beliefs from the basic values of Islam. Islamic banks do not consider their purpose to be solely economic; rather they are instruments for accomplishing the spiritual and religious values of human beings. Prince Muhammad Al-Faisal Al-Saud, chairman of DMI and president of IAIB, commented on this point, noting that when the Islamic bank accepts deposits, the purpose is not to increase its power to lend and collect interest, but to instil in Muslims the spirit of saving and to get them to plan for the future of their families. Prince Muhammad went on to say that the Islamic banks grant production loans in order to assert the spiritual role of labor, and they invest funds not for profit alone, but in order to attract idle funds, particularly those that are in the hands of people who have doubts about dealing with the conventional banks.[28]

The developmental aspect The word 'development' has the connotation of economic endeavors that involve the pursuit of material and financial gain. Modern economic thought, however, maintains the view that economic development should elevate the mind as well as the spirit of society. Islamic society concentrates on psychological, mental, social, and moral development. Concentration on this type of development will supposedly lead to a happier, healthier, and prosperous society. The *Encyclopedia of Islamic Banks* states that the economic role of the non-Islamic bank is to gather funds and channel them to those who are in need of capital in order to accomplish their profit objective, but the economic role of Islamic banks is to advance society in all development endeavors, the profit realization being the means and not the end.[29] For this reason Islamic banks encourage savers to make deposits regardless of size. The small deposits may not realize adequate return and may even lead to losses in the economic sense, but the Islamic bank encourages persons of moderate means to save their excess cash in order to develop the saving habit, because one of its objectives is to develop the savers' personality, not their material interest alone.[30] It does so in order to promote a sense of planning and efficiency in the use of their economic resources. As a result, dealing with banks will become an acceptable practice in Muslim society.

The investment aspect Conventional banks depend mainly on the interest differential for their livelihood. The difference between interest received from borrowers and interest paid to depositors constitutes the bulk of their profit. Islamic banks do not extend any loans except what are referred to as 'out of goodness loans', which are interest-free loans that may involve service charges to cover the administrative costs of the bank. The service charge is by no means a percentage of the loan amount. The *Encyclopedia of Islamic Banks* points out that the difference between the lending aspect of the conventional banks and the investment aspect of the Islamic banks is quite clear and of utmost importance. The conventional banks are almost risk-free because, contrary to Islamic bank practices, they ask for sufficient collateral to guarantee the collection of the specified interest and the return of the principal of the loan at maturity.[31] It is true that the conventional banks carry out a special investigation of the financial strength of the borrower and the arrangements made for the repayment of the loan, but at the end the bank is almost sure that the loan will be repaid. In the case of most Islamic banks the story is different because it is the bank which seeks the investment opportunities and makes the necessary feasibility studies of the projects. The bank may do this alone or in cooperation with other investors. The bank in its feasibility study may do its best to ensure that the project is based on sound market and industrial conditions, up-to-date technology, and other financial considerations; but the risk will still exist.[32] This risk may be shared by the bank and other investors by various Islamic investment methods discussed in the following chapter.

The ban on interest in the operations of Islamic banks places a heavy burden on the kinds and methods of investment utilized. The *Encyclopedia of Islamic Banks* stressed the point that due to this burden the Islamic bank is forced to look for investment opportunities in all sectors of the economy: agricultural, industrial, commercial, service, and others. The Islamic bank does not confine its investment to the sector that promises to yield a high and quick return, but looks for investment projects that give a long-term social return such as those in infrastructure.[33] In practice, however, when management is faced, in certain periods, with high cash balances and delays in investing in long-term projects in infrastructure and basic sectors, it resorts to other projects that secure adequate return and conform to financially and religiously permitted practices.

Islamic banks face a real challenge because out of their profits on investment they have to provide their depositors with a higher rate of return than the rate paid in interest on comparable financial securities and savings accounts, because the Islamic banks' depositors assume a greater degree of risk. According to the *Encyclopedia of Islamic Banks*, the real purpose of the bank is to concentrate on the return paid to the participating partners in ventures funded by the bank and on the return on investment made by the bank itself. The latter return includes the direct profit realized by the Islamic bank and the social return realized by the Islamic society. The Islamic bank then appeals to the Islamic incentive and to the Islamic consciousness of the depositors and other individuals and organizations associated with the investment.[34] This fact places

a heavy responsibility on the management of the Islamic bank and particularly its research divisions which prepare the feasibility study and make the appropriate recommendations for the selection of investments. The research department team will have to be equipped with technical know-how, knowledge of the market and financial conditions, and above all with knowledge of the Islamic principles.

The positive attitude Advocates of Islamic banking feel that conventional banks assume a passive role towards the investors borrowing funds secured by collateral because the fixed return on the loans is known to these banks ahead of time. As a result, the conventional banks do not perform an active role in the economic projects undertaken by investors. These banks are said not even to have the right to advise and consult on the issues involved in the investment.[15] This contention is not true because conventional banks have to consider the consequences of failure of the investment, bankruptcy, and defaults on repayment of the loan. Furthermore, small investors who are in difficulty and need the loans badly are subjected to a high interest rate, a situation which adds to their risk and worry because the lender does not care except about the collection of the interest and the repayment of the principal. The Islamic view on this issue is that if the borrower finds the interest rate prohibitive then he will refrain from making the investment. A passive attitude on the part of the bank will induce a passive attitude on the part of those who make the investment, and as a result the national potential for production will not be realized. Another result of this situation is the passive attitude of depositors who save their money at the bank and save themselves the trouble of taking the risk in the investment market. The conventional banks benefit from this situation because the deposits add to their lending ability and financial strength.

If the depositors of large amounts of savings are brought into the picture, then their attitudes become passive to the point where they earn benefits from their funds without real effort, a point which contradicts the teaching of Islam on the role of labor and work in the development of the Islamic society. The Muslim scholars feel that those who introduced interest taking into the financial operations of the Muslim world intended to undermine the positive aspect of the Islamic views on finance and economics. They also feel that the conventional banks' emphasis on interest and the principle of trading on the equity in financial management provides them with a stable banking system that brings maximum profit to the bank owners. It might be concluded that the positive aspect of Islamic banking defies the trading on the equity concept as well as the interest concept altogether.

The social aspect The social aspect of Islamic banks stems from the fact that these banks provide a service that involves the collection of Zakat funds and the distribution of these funds to the parties specified in the Qur'an. They also administer cash funds, of individuals or organizations, for social purposes.

Supporters of the concept of Islamic banking feel that the type of projects or ventures Islamic banks invest in generate numerous social benefits.

The Articles of Agreement of most Islamic banks state that these banks administer Zakat funds for the purpose of helping Muslims in the fulfilment of their religious duties. These banks administer also, on behalf of individuals and organizations, social funds established for educational, cultural, scientific, and charitable purposes. In addition, they feel that the investment aspect turns the Islamic bank into a social bank. The methods of operation of the Islamic banks, which are based on profit participation, fulfil the objective of wealth distribution and lessen concentration of wealth. The return on investment, which is supposedly higher than the interest income, will go to the bank owners and depositors of savings equally. In the conventional banks the owners or stockholders receive most of a bank's income whereas the savers, particularly the small savers, receive a meager rate of interest which recently in most cases has been lower than the inflation rate, a situation that reduces the purchasing power of the depositors' savings. This rate of interest, agreed upon at the beginning, may be increased when deposits are scarce, but it does not increase proportionately with the bank's income from all sources, banking services and loans. In the case of Islamic banks, the total profit made on investment through productive investment and efficient management goes to the depositors in a more equitable manner than is true for the conventional banks.

Another social aspect of Islamic banks stems from the involvement of these banks in what is called 'cooperative insurance' and 'cooperative hazards funds'. The cooperative insurance schemes' net profits go to the insured participants in the form of reduced premiums. Cooperative and solidarity life insurance plans are available where premiums are invested and profits accumulated to the insured Muslims. If the insured dies before he reaches his 65th birthday and completes the premium payments, his legal heirs receive all the premiums he paid before his death, the accumulated profits on the paid premiums, and the unpaid premium amounts. The latter are paid out of profits made from the investment of the insurance premiums collected from all insured persons who joined the plan.

Organizational Framework

Islamic banks differ in form of ownership and in emphasis on certain goals and methods of operation. The geographical scope of operations, the size of the bank, the age, the people involved in the management, and the customers, or rather the participating owners (depositors and investors), cause these banks to differ in their form of organization.

If the general objectives are taken into consideration, the suggested organizational structure for Islamic banks, which appears in the first volume of *The Practical and Scientific Encyclopedia of Islamic Banks*, seems to provide a reasonable standard (See Figure 6.1). However, it is found in practice that even though this basic structure is adhered to by most banks, there are some which

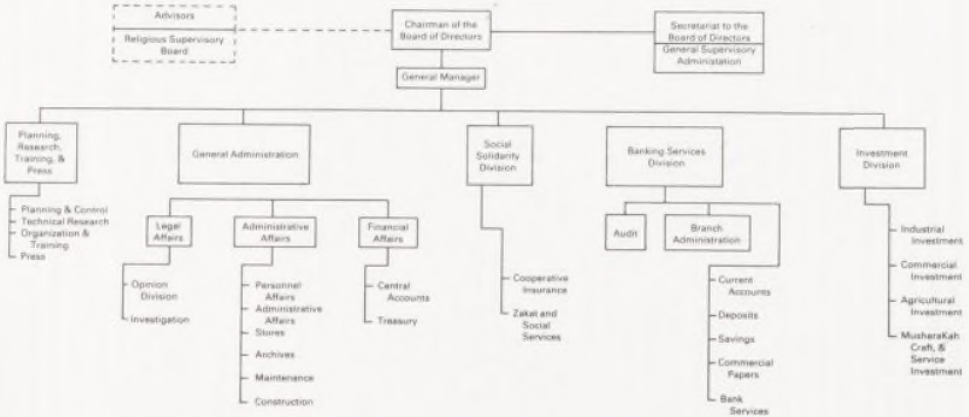

Figure 6.1 Organizational structure for Islamic banks. Source: Adapted from *The Practical and Scientific Encyclopedia of Islamic Banks*, vol. 1 (International Association of Islamic Banks, 1977), p. 67

offer more services in one of the functional areas or which may give different priorities within these functional areas. For example, the Nasser Social Bank emphasizes the function of the social solidarity division, particularly in the areas of providing social security insurance and cooperative insurance for those who are not eligible for benefits under the government social security system. It also gives priority treatment to the collection and distribution of the Zakat and to the 'loan out of goodness' (Kard Al-Hasan) with emphasis on loans to apprentices and needy college students.

On the other hand, the Islamic Development Bank, which is quite different from the other Islamic banks, is not expected to deal with small customers because its main sources of development funds are the governments of the Islamic countries, and its main objective is to tackle the problems of satisfying the need for funds for large-scale economic development projects. Its investment participation and lending activities are limited in scope to productive purposes in the member countries. The organizational structure of this bank does not include a division for deposits, savings, and banking services; however, it is expected to have a main research division well staffed with experts in feasibility studies and financial and national economic analysis. According to Article 37 of its Articles of Agreement, the management and staff of this bank should include people who are politically impartial, and they should never interfere in the internal political affairs of the member countries.

There are Islamic banks, such as the Kuwait Finance House, which plan emphasis on investment, directly or through participation. Other functions are not ignored by the KFH, but they are given lower priority in order to meet the main objectives stated in its Articles of Agreement. However, the majority of the Islamic banks offer services to all customers and invest in many economic sectors, all within the framework of the Islamic principles.

Finally, the government ownership domination of Islamic banks encourages a high degree of bureaucracy and more emphasis on national political involvement. These factors influence the organizational structure and staffing of the banks' management and personnel. The form of organizational structure is of the utmost importance to the orderly, timely, and efficient fulfilment of the objectives of any organization. Within the Islamic banks, emphasis is placed on the application of the Islamic principles to all banking operations, and the absence of a religious supervisory board constitutes a serious departure from the standard organizational structure. In modern business there are practices that may not be accepted by the religious authorities and careful application of the basic principles of Islam are required. Making correct deductions and interpretations needs to be done by those who have the necessary knowledge and religious educational background and who have an open mind, a fresh outlook on modern and new things in life, and, above all, the courage to come forward and declare their judgment. For this reason the inclusion of the religious supervisory board in the organizational structure is important, yet we

find that the Islamic Development Bank does not have such a board. It is possible that the bank considers itself exempt from such a need because it is an instrument for the fulfilment of the objectives of the member countries of the Islamic Conference. However, the emphasis on the application of the Islamic principles is evident throughout its Articles of Agreement.

To date, the most sophisticated and massive of Islamic banks is the Dar Al-Maal Al-Islami (DMI), or the Islamic Financial House (see Figure 6.2). This organization involves a group of companies organized to operate in the areas of investment, banking, business, and Islamic solidarity with a total authorized equity capitalization of $1.0 billion to be subscribed to and paid for over the 5 years ending 1985/1986. The DMI is a relatively new organization, founded in February 1981 by several influential leaders of states and successful businessmen from countries such as Bahrain, Egypt, Guinea, Kuwait, Malaysia, Pakistan, Qatar, Saudi Arabia, Sudan, and the United Arab Emirates.[36]

In order to ensure its success, the DMI planned to acquire operating subsidiaries formed in Muslim and other states. These existing businesses should provide the DMI with the needed expertise and personnel. In January 1982, the operating assets, now utilizied in the conduct of Islamic financial businesses from an existing Islamic financial organization called the Islamic Investment Company, were acquired by the DMI.[37] The interesting point about the size and organizational structure of the DMI is the fact that Islamic banks are not localized, small, and limited economic and financial institutions. On the contrary, a structure such as that of the DMI illustrates the determination of the people who are behind Islamic banking to support the idea, but the ultimate success and competitiveness of these banks remain to be tested in the next few years.

THE RELATIONSHIP OF ISLAMIC BANKS TO THE SAUDI FINANCIAL SYSTEM

The previous chapters have attempted to explain the major aspects of the Saudi financial system, including financial markets, financial institutions, banking regulations, and other monetary and economic considerations. Keeping in mind the developments, trends, and problems in the Saudi financial system, it is sensible to consider some alternatives for tapping the tremendous potential of the Saudi economy. These alternatives are manifested in the existence of Islamic banking operations in Saudi Arabia and neighboring countries. The relationship of the existing Islamic banks to the Saudi financial system stems from the fact that Saudi Arabia is the heart of the Islamic world. The interaction of Islamic banks with some elements of the Saudi financial system and with the Saudi people is a reality. This reality will be explained by indicating (1) the status of Islamic banks in Saudi Arabia and (2) the relationship of the Islamic banks to the Saudi financial institutiions.

The Status of Islamic Banks in Saudi Arabia

The Saudi government and the Saudi people have supported and encouraged the movement of Islamic banking. This support is manifested in the establishment of the Islamic Development Bank with headquarters in Jiddah, Saudi Arabia. The Saudi government contributed 25 percent of the total authorized capital of this bank, and other Muslim governments contributed the balance. In addition, the Islamic Investment Company (IIC), a subsidiary of Dar Al-Maal Al-Islami with headquarters in Geneva, has 18 operating branches in the major cities of Saudi Arabia. The branches of the IIC have a 'quasi-legal' status, operate under the sponsorship of Prince Muhammad Al-Faisal Al-Saud, and accept deposits in the form of savings accounts, time certificates, and cooperative life insurance premiums. DMI itself had financed twelve economic projects in Saudi Arabia by mid-1982. Another Islamic institution operating in Saudi Arabia is the Islamic Insurance Company, a subsidiary of the Faisal Islamic Bank of Sudan. This company offers most types of Shariah-approved cooperative insurance, except life insurance. Another indication of the apparent receptivity of the Saudis to Islamic institutions is the fact that Saudi Arabia hosts the International Association of Islamic Banks in Jiddah.

The Supreme Scholars of the Kingdom of Saudi Arabia approved ten different Modarabah certificates offered by DMI as conforming to Islamic rules, principles, and traditions. This Saudi religious approval is crucial to the acceptance of the concept of Islamic banking not just in Saudi Arabia, but in the Muslim communities all over the world.

Another indication of the Saudi support given to Islamic banking is the fact that a good number of founders and members of boards of directors of Islamic banks are Saudi citizens or Saudis residing in countries where Islamic banks are located. The fact is that there are non-Saudi Islamic banks operating, to a limited extent, in Saudi Arabia, but they are not under the umbrella of the central banking authority, SAMA. These banks are competing for deposit funds with the Saudi conventional commercial banks and participating in the investment activities of the kingdom. The extent of this competition is not known, but DMI estimated that deposits with branch offices of its subsidiary IIC in Saudi Arabia average SR 160 million ($46 million) per month.[28]

The Relationship of the Islamic Banks to the Saudi Financial Institutions

In order to understand the relationship of the Islamic banks to the various elements of the Saudi financial system, particularly the legal element, it is important to look into their relationship with SAMA. The applicability of the Saudi Banking Control Law to the accomplishment of the objectives of the Islamic banks, and its suitability as a vehicle, is an important aspect of this relationship. Islamic banks are multipurpose banks. They offer traditional banking services, except that they do not grant interest-bearing loans, and they

make investment in the form of equity participation. The relationship of Islamic banks to the Saudi Financial System is divided into (1) the relationship with SAMA, (2) the relationship with the commercial banks, and (3) the relationship with the specialized credit agencies (funding agencies).

The Relationship with SAMA

SAMA's legal power is derived from the 1966 Banking Control Law. It is necessary to recall that the major SAMA tool for supervising the commercial banks is that of the statutory deposit requirements. These requirements are designed to restrict loans and advances to customers and to protect depositors. In addition, the commercial banks are proscribed from owning real estate or other businesses and may not engage in wholesale or retail trade (see Appendix B).

These restrictions are not conducive to Islamic banking because the objectives of the Islamic banks imply, to a large extent, freedom in investing and in offering multipurpose services to the public. The commercial banks are able to show, even with the restrictions imposed, above average profits because they are in the business of short-term lending with interest. This is true despite the fact that the banks do not receive interest on deposits with SAMA. If Islamic banks operate as commercial banks they cannot survive under the existing conditions. New banking laws may be enacted in order to accommodate the Islamic banks' multipurpose operations. Since Islamic banking is a relatively new concept, it may be given a chance to operate in Saudi Arabia under the umbrella of SAMA. The issue is that in other Muslim and non-Muslim countries Islamic banks were licensed to operate, but were not exempted from being under the supervision of central banks. Customers feel more secure when Islamic banks are subject to the legal restrictions of the central banking authority. Given these restrictions, Islamic banks have to be managed efficiently in order to survive the competition from the commercial banks. The establishment of Islamic banks in Saudi Arabia would complement the successful efforts of SAMA in strengthening the expansion of commercial banks and in encouraging banking habits among the Saudi population.

The Relationship with Saudi Commercial Banks

Competition is the major issue in the relationship between Islamic banks and the Saudi commercial banks. Currently, the only Islamic bank competing in Saudi Arabia directly with the Saudi banks for deposit funds is the Islamic Investment Company. However, the IIC does not offer banking services or grant loans; consequently, it is not a commercial bank. Its existence in Saudi Arabia, however, adds to the competition in the banking world. The IIC has been paying between 11 and 17 percent return on deposits to its customers.[38] The return varies with the amount of profits generated from the investment projects financed by the deposited funds. Customers, Saudis and non-Saudis alike, who used to hoard their savings or keep their funds in the Saudi commercial banks and who reject receiving any interest because of their religious conviction that interest is forbidden, started to invest their funds the Islamic way through deposits with the IIC. Hoarding is widely prevalent in the Gulf and the Arabian Peninsula; it is estimated by the International Association of Islamic Banks at $12 billion in Saudi Arabia alone and $40 billion in the Middle East as a whole.[40]

If Islamic banks are established in Saudi Arabia they can contribute to the kingdom's economic development by attracting the untapped savings of the people who at present do not deal with banks, the people who deal with banks only for the purpose of cash safekeeping, and the people who have savings accounts at commercial banks, in conflict with their religious convictions. The real contribution of Islamic banks comes from their investment activities in development projects on equity participation basis.

The Relationship with the Specialized Credit Agencies

In the absence of a capital market in Saudi Arabia, the need for the specialized credit agencies, to accelerate economic activities in the productive sectors of the economy, is quite evident. The Saudi specialized credit agencies, as noted in Chapter 5, provide not just long-term loans but technical assistance as well. The principal motive behind the establishment of these agencies is the deployment of government funds to complement and add to private investment, and to provide funds for sectors which are not attractive to the private lenders. Financial maturity in the Saudi private sector, then, is an essential objective for the continuation of economic and financial growth in the country. These agencies grant loans without any interest charges. In many cases, however, the loans are granted with a flat 2 percent charge for recovery of administrative expenses. The question is: Can these agencies continue to provide funds without charging interest on their outstanding loans? If they are to continue they have to charge interest and impose rigorous loan repayment schedules, or become partners in the funded projects and draw their share of the resulting profits. There are indications that these agencies may become state banks to be managed in accordance with banking administration practices.[41] In this case, they will probably conform to the government policy of abiding by the Shariah and adopt investment methods similar to those used by Islamic banks.

Islamic banks, as stated earlier, are already investing in Saudi Arabia. They are taking advantage of the Foreign Capital Investment Law which provides substantial privileges and benefits, including tax exemptions (see Appendix C). Accordingly, they are allowed to invest in projects that may not be funded by the Saudi specialized credit agencies. The role of Islamic banks in this endeavor may be enhanced if they are established in the kingdom according to a special law and under the supervision of SAMA.

Whether Islamic banks will become a part of the Saudi financial system is not

certain at this time. According to an official of Dar Al-Maal Al-Islami, licensing of DMI by SAMA is inevitable.[42] This claim may prove to be true, given the fact that DMI is supported by several Saudi princes and its investment Modarabah certificates are approved by the Saudi religious authorities. The fact that DMI is internationally based and recognized, and that its financial statements are audited by the highly regarded auditing firm, Price Waterhouse & Co., gives its aspirations additional credibility. On the other hand, the move by the Saudi authorities to regulate money exchangers who supposedly do not receive or pay interest (Resolution No. 3/920, dated 12 December, 1981) is unequivocal and clearly proves the rejection of all claims for the money-changing community to be seen as a base for an Islamic non-interest banking system in Saudi Arabia.[43] This move may also provide an indication that official approval of DMI, or any other Islamic bank, by the Saudi authorities may be very elusive.

DISCUSSION QUESTIONS

6.1 Is there any difference between Western and Islamic definitions of 'interest' and 'usury'?

6.2 It is stated in the Qur'an that 'Allah hath permitted trade and forbidden usury'. Discuss the logic behind this Qur'nic verse.

6.3 What are the social and economic implications of the arguments for and against permitting interest on consumption and production loans? Discuss.

6.4 What is the responsibility of the Islamic state in the absence of the use of interest in lending activities?

6.5 State the meaning of Zakat and discuss its moral, economic, and social contributions in the Muslim society.

6.6 Is there any relationship between the institution of Zakat and the concept of interest? Discuss.

6.7 Discuss the history of Islamic banking in Egypt.

6.8 Describe the development of Islamic banks in the 1970s and 1980s. What are the unique characteristics of these banks?

6.9 With the growth of the Islamic banking movement, the need for a technical advisory body was realized and led to the establishment of the International Association of Islamic Banks (IAIB). What are the practical reasons for the IAIB and what are some of its achievements?

6.10 Define, in your own terms, the concept of 'Islamic banking' and explain the general and specific objectives of Islamic banks.

6.11 Explain the ideological aspects of Islamic banks. How do most Islamic banks comply with the principles of the Islamic Shariah?

6.12 Modern economic thought maintains the view that economic development should elevate the mind as well as the spirit of society. How does this thought apply to the development philosophy of Islamic and non-Islamic banks?

6.13 Discuss the risk aspect of lending and investment in Islamic and non-Islamic banks. What are the practices followed by these banks to avert or minimize risk?
6.14 The investment aspect of Islamic banking leads the Islamic banks to a serious challenge. What is the nature of this challenge and how have the Islamic banks responded to it?
6.15 Advocates of Islamic banking refer to the passive role assumed by conventional bank managements and depositors. What are these roles and what is their impact on the national productive potential?
6.16 The chapter concluded that the positive aspect of Islamic banking defies the trading on the equity concept as well as the interest concept. Explain.
6.17 Discuss the social aspects of Islamic banking.
6.18 Is the Islamic bank organizational framework different from that of conventional banks? Explain.
6.19 What is the status of Islamic banks in Saudi Arabia? Discuss the extent of the support given to these banks by the Saudi government and people.
6.20 Explain the most important aspects of Islamic banking as they relate to the development of the Saudi financial system.
6.21 Is the Saudi Foreign Investment Law conducive to Islamic bank investment in Saudi Arabia? Explain.
6.22 Do you envisage that the Islamic banks will become a part of the Saudi financial system? Explain.

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CHAPTER 7

Islamic Banks: Operating Methods and Services

INTRODUCTION

Since paying or receiving interest is prohibited in Islam, Islamic banks resort to generation of income from fees for services, profit sharing from equity participation, trading in commodities and foreign exchange, building and management of industrial and agricultural businesses, rental businesses, real estate, and other transactions that involve risk and do not violate Islamic principles. Islamic banks also do not invest their funds in business ventures that guarantee fixed and predetermined rates of income, but rather invest in projects on an equity basis where the rate of return on investment fluctuates with the actual profit realized from the projects. Certificates of deposits, government bills and bonds, corporate bonds, or consumer loans are consequently instruments that Islamic banks do not in any circumstances invest in because they violate Islamic principles.

In this chapter the operating methods and services of Islamic banks are explained in the light of their conformity to Islamic principles, of their utilization for the purpose of accomplishing the objectives of the banks, and of their contribution to the economic and social development of the Muslim countries. Islamic banking methods of operation are not uniform. However, Islamic banks, including the ones operating in Saudi Arabia, adhere to Islamic principles. In this regard, they all seek the approval of the religious authorities and most require authorized certification from their own religious supervisory boards attesting that their banking methods and services are in compliance with Islam. Islamic banks are engaged in two types of activity: investment and risk administration and 'regular' banking and social services. The first activity, investment and risk administration, is discussed first followed by banking and social services.

INVESTMENT AND RISK ADMINISTRATION

Investment

Islamic investment activities include direct investment, Musharakah (participation), Modarabah (Quirad), Murabahah, and leasing.

Direct Investment

Islamic banks may make direct investment in projects. This type of investment may involve many business activities such as trading and management of real estate properties, precious metals, import and export, purchase and rental of equipment, storage facilities, or other investments that do not necessarily involve any joint ownership or sharing of profit with others. The involvement of Islamic banks with direct investment in complicated projects that require special technical and managerial skills has been minimal. Some Islamic banks are restricted by their articles of incorporation from making such investments. For example, the Jordan Islamic bank 'may invest funds in various projects directly, provided that the total permanent investments of the Bank do not exceed seventy percent of the total paid up capital and compulsory reserve'.[1] The Articles of Agreement of the Islamic Development Bank state that 'the Bank shall not acquire a majority or controlling interest in the share capital of the project or enterprise in which it participates except when it is necessary to protect the Bank's interest or to ensure the success of such project or enterprise'.[2]

Most Islamic banks are not specific about the limitation of direct investment; however, they state that investment in new or existing projects, whether short-term or long-term, is subject to the bank's financial conditions. Technical and managerial considerations, as well as limitations specified by laws and regulations of the country in which the bank operates, constitute other limitations imposed on direct investment.

Musharakah (Participation)

'Musharakah' means a profit-sharing joint venture designed for a certain operation and ending within an agreed-upon period of time. The two parties to this temporary participation, the bank and the customer, contribute capital assets as well as technical and managerial expertise in varying proportions, and they share the realized profit in a ratio agreed upon in advance. These shares are not uniform for all cases. For example, a client may participate with the bank in financing a commercial or industrial project whereby he contributes 25 percent and the bank 75 percent of the needed capital. The agreement provides that the client manages the project, and in return he receives 20 to 40 percent of the actual realized profit. The bank does not interfere in the management, but periodically audits the operations. The balance of the actual profit will be divided according to the capital contribution ratio. In case of a loss, the Shariah directs that the loss distribution is identical to the capital contribution ratio without any modification.[3] In other words, the parties simply lose according to the share owned in the equity of the project.

The Shariah allows the bank to ask for guarantees and collateral from the client, not in the capacity of the client as a participating partner but as a manager of the project, in order to assure the bank of honest and efficient management. The success of this method of operation depends on the ability of the bank to do the following:

(1) choose appropriate clients;
(2) make a realistic feasibility study of the project;
(3) follow up the project through audit and periodic control techniques.

One of the main advantages of Musharakah is the understanding that the bank is a participating partner and behaves as such if expectations of sale of the commodities or the manufactured products are not fulfilled and more time is needed. In this case, the managing partner is not pressurized by the bank on account of the added costs, as he would be if conventional interest-financing methods were used, or on account of urgency to refinance and pay back any loans contributed by the bank. To assist in the success of the project, the bank keeps track of the current market price of the commodity and communicates this information, along with other related important information, to the managing partner. The bank may also advise the partner on the timing of the sale of the product and exchange useful information with him.[4]

One of the advocates of Musharakah has commented on its value in terms of its contribution to social and economic development of the Third World countries by stating that

> the Musharakah method places a heavy managerial burden on the bank manifested by the need for the project feasibility study and follow up of the project. For this reason we believe that Islamic banking is closer to the fulfillment of the objectives of development as compared with other methods of banking because the shortage of management skills is a major problem in the developing countries.[5]

This method is dynamic and helpful to clients in terms of choosing, planning, and managing projects. Flexibility in setting the profit margin on the project, in lieu of concern for the strait-jacket of fixed interest, is one of its profound advantages because the bank can lower its profit share on those projects considered important in the development of the country, taking into consideration the economic and social needs of local communities.

Even though Musharakah covers all types of needed short-term financing, it may be used in medium- and long-term financing projects. For example, the Islamic Bank of Sudan has used the Musharakah method for financing equipment, machines, and other production facilities needed by selected professions for periods that might extend to 3 years.

There is a more highly developed form of participation, 'decreasing participation', which is based on an agreement whereby the bank and client contribute capital to the joint venture. The parties to the venture agree that the bank will receive a certain part of the net profit realized, with the remaining profits, or any part thereof, applied against funds advanced by the bank. When the full

amount of the capital contributed by the bank has been offset by profit receipts, complete ownership of the venture will be transferred to the client.

Modarabah (Quirad)

The history of Modarabah commences in the pre-Islamic period when the savings of the elderly, women, children, and sick people were given to merchants of the Quresh tribe for an agreed-upon part of the generated profit from certain trade or venture activities. This practice was approved by the Prophet Muhammad. In the context of Islamic banking, Modarabah may be defined as a contract between two parties in which the Modareb (the bank) pays a certain sum of money to the businessman or entrepreneurial client, for the purpose of investment in a specified profit-making trade or project, and the Modareb and the entrepreneur share the profits in an agreed-upon ratio.

The difference between Musharakah and Modarabah lies in the fact that in the Musharakah, if the business incurs a loss, both parties bear the loss. With Modarabah, the Modareb bears the loss; the entrepreneur loses the reward for his efforts but does not bear any of the financial loss as long as he is not negligent. The entrepreneur has to repay the original sum to the Modareb in case he is negligent.

Accumulated profits may be distributed during the Modarabah or at the end of the contract. Any profits received by the Modareb become his even if a loss occurs later. No fixed rate of profit can be guaranteed or specified ahead of time or before the realization of the profit itself. Furthermore, the customer must not guarantee the return of the contributed original sum to the bank because the financial transaction then would be classified as a loan from the bank to the customer. In this case the main condition of the Modarabah would be violated and the Modareb, who supplied the capital, could not receive any of the profit. Modarabah is popular in Islamic banking because it is a mechanism for economic development in which monetary assets are introduced into the production process in order to transform them into real factors of production. Consequently, both the owner of the assets and the entrepreneur who contributes his labor and managerial effort share the outcome of the process. From a theoretical point of view the Modarabah has a dual basis in the principles of constancy of ownership and cooperation. The first principle implies that the Modareb has full claim on his monetary assets as well as on the increase in output resulting from the combination of these assets and the labor hired by the entrepreneur in the production process. The second principle implies that the two parties, sharing the elements that create the project and the interest in it, also share the fruits of it in the full sense of the word 'share', which cannot be realized by a fixed return to one party such as when one of them receives a specified rate of interest.

The adoption of Modarabah by the Islamic bank stems from the realization that it provides an Islamic solution to the economic dilemma of how the owner of monetary assets and the businessman can be brought together on common

ground. Modarabah is the solution which coordinates the interests of the two parties and fits the objectives of Islamic system.[6]

The Modarabah contract offers an opportunity for collective investment to those who lack managerial and technical skills, and also lack the ability to take risks because of the small size of their savings. There is no doubt that prudent investment in business today is a complicated matter, particularly with the erratic fluctuations of interest rates, the high level of inflation, and the complexity of technology and management of business operations. This condition leads the advocates of Islamic banking to argue that the need for a method to enable persons with excess funds but lacking the necessary commercial expertise and supervisory ability to utilize the services of the knowledgeable is far greater than it was during the time of the Prophet.[7]

Murabahah (Sale on Credit)

This method of financing involves purchasing for others on a pre-agreed profit basis. Murabahah is a method of commerical investment in which a client requests the bank to buy certain commodities or assets, and promises to buy the goods from the bank at a set profit and at a set time. This method of operation is directly related to the documentary letter of credit. According to the Shariah, the bank's agreement to buy and the execution of the purchase do not impose a legal obligation on the customer to buy. The bank takes a risk, which justifies the profit, until the client fulfils his original promise to purchase the commodity.

Confusion of this technique with financing through a fixed interest rate loan is accomplished by making an analogy with the exchange of money (the bank's payment to the supplier of the goods) for more money (the amount received from the client importing the goods), which is the original amount paid by the bank plus the agreed-upon profit. However, there is a striking difference between the two options because in loan financing the client is obliged to pay the loan principal along with interest, whereas in the case of Murabahah the customer is not obliged to buy the goods when they arrive. The bank cannot even accept an advance on the purchase. Since the goods are shipped in the client's name, he must give an endorsement to the bank in order to clear the goods through customs in case he refuses to accept the goods and the bank is obliged to sell them in the marketplace.

In Murabahah, payment by the client may be made in instalments and the bank may ask for collateral or some other guarantee; however, the bank should not increase the price of the sale in any circumstances, and if the client makes a late payment he should not be penalized with an extra charge. The Murabahah method of financing has become a popular method of developing inter-Islamic trade and improving the balance of trade between some Muslim countries. The Saudi-based Islamic Development Bank is promoting this method of foreign trade financing among its member countries, particularly in the oil trade sector. The IDB is buying commodities of a development nature, preferably from

within the membership and as requested by a member country, and it then transfers the ownership. The bank is paid later, generating a profit from the mark-up on the sale, usually 8 percent or so, and the beneficiary country gains from the deferred payment. The IDB usually insists on goods at a competitive price and from an Islamic source. The IDB also restricts the deals to commodities for development rather than consumption, including oil, refined petroleum products, palm oil, cement, and cotton and jute products.[8]

In 1977 the IDB began promoting this type of financing by supporting five transactions at a cost of US$50.52 million. The feasibility of this type of transaction was obvious as the IDB realized the benefit of investing its excess funds instead of leaving them as deposits with the Saudi Arabian Monetary Agency. Between 1977 and November 1982, the IDB financed 145 similar operations totalling US$1949.56 million, approximately two thirds of the total amount of all operations approved by the bank.[9] The increase in operations in Murabahah form is not unique to the IDB. For example, the number of Murabahah customers at the Dubai Islamic Bank increased from 335 in 1980 to 953 in 1981, and to 3300 in 1982.[10]

Leasing

Leasing is a new type of long-term financing which has gained popularity in the industrialized world. The leasing method accepted by the Shariah takes the form of straight rental financing or lease-purchase financing. In straight rental financing, the bank purchases a capital asset and leases it to a beneficiary (the lessee) in return for an agreed-upon annual or monthly rent. The lease-purchase financing arrangement is based on profit sharing in which the bank buys the capital asset and leases it to the client for a limited period of time. The amount of rent collected from the lease, which constitutes the bank's return, is not calculated on the basis of the bank's capital involved, but rather on the profitability of the asset once it is employed by the beneficiary, with careful reference to cash flow.[11] When the bank buys the capital asset it is understood that eventually the capital will be repaid to the bank and the ownership transferred to the borrower. Such a payment may be made in one lump sum, as in the case of leasing arrangements developed by the Islamic Development Bank.[12] However, in the case of Islamic banks which offer savings account services, the client (the lessee) makes agreed-upon payments in instalments into a savings account over a specified time period. The accumulated profits generated from the payments, and the payments themselves, are reinvested in the bank's investment projects over the time period of the lease, contributing to the eventual purchase of the leased asset. Leasing then, according to Islam, does not involve interest because its outcome is either a sale–purchase type of transaction or a rent transaction.

The IDB utilized the leasing method effectively between 1975 and 1982, financing 26 operations through lease arrangements that amounted to US$253.34 million, 29 percent of the total financing for all IDB operations,

excluding foreign trade financing. The IDB leasing operations include port handling equipment, locomotives, refrigerated ships, bulk carrier ships, fishing vessels, construction equipment, and tires and tube production equipment.[13]

Risk Administration

In general, risk is defined as the probability of the occurrence of unfavorable outcomes.[14] Profits generated from investment projects are affected by the degree of risk taken. The return on investment has a strong relationship to the valuation of assets or net worth of business and financial organizations. To understand the relationship between risk and return in Islamic banking, it is important to examine the return from each form of investment and to evaluate the safeguards and control measures taken by Islamic banks to minimize risk and maximize the value of the banks' assets.

Risks in Operations

Risks in Islamic banking operations are confined to investment transactions and have no part to play in other operations such as the regular banking and social services. Under adverse business conditions, the risks assumed by all banks, Islamic or conventional, are the same because the ability of the customers to repay the bank funds when due is similarly reduced, regardless of the nature and objectives of the banks. Under normal economic conditions, however, the conventional banks receive a fixed and agreed-upon rate of interest on their borrowed funds. This fixed rate of interest is prohibited by the Shariah, and instead profit generation is allowed from equity participation and other methods of investment. If the Islamic bank makes a direct investment in a business project the risk taken does not differ from any other risk taken by businessmen, companies, or other banks. The issue of project profitability and feasibility is important in direct investment. In the Musharakah form of investment, the bank and the bank's client contribute funds to the investment project. The Musharakah involves a degree of risk which depends on the technical and managerial authority granted to the client who becomes a participating partner. The bank has the right to participate in the management process, but it may delegate that function to the participating partner who will have control over the operations. It is important to point out that according to the Shariah the Islamic bank cannot ask for collateral and if the bank requires any guarantees they will be related to the management of the project and the ability of the partner to abide by the legal terms of the contract.[15] The partner's previous experience, reputation in the community, letters of reference, or credit rating may provide adequate protection for the bank.

In the Modarabah form of investment the degree of risk assumed by the bank is greater than that assumed in the case of the Musharakah form. Both parties bear any losses in Musharakah, whereas in Modarabah the bank alone bears

the financial loss and the business partner merely loses any compensation for his efforts, as long as he is not negligent. For this reason, the ability of the Islamic bank to choose an experienced managing partner who engages in efficient and moral practices determines the degree of risk taken. In both forms of investment operation, the Musharakah and the Modarabah, the degree of risk taken by the bank is great. This is particularly true because, according to the objectives of Islamic banking, the bank is committed to assist businessmen, craftsmen, or artisans who are just beginning to acquire the means of production.

The risk related to the Murabahah method is different because this method involves a sale on credit where the client requests the bank to buy certain goods and promises to purchase them at a certain price that includes a set profit, and the total amount of the price and the profit is paid at a specified time. The risk in this method lies in the fact that the customer is not obliged to buy the goods, and if he refuses to take delivery and pay at the time of arrival of the goods then the bank will have to sell them to another buyer, or store them, or dispose of them. It should be reiterated that collateral or guarantee may be requested from the customer if the amount of the Murabahah is to be paid in instalments in order to reduce the degree of risk assumed by the bank.

Leasing also involves risks because the determination of the rent is based on the future profitability of the rented assets and expected cash flow and not on the market rate of interest or the discounted future return. Use of this method requires careful planning and follow-up in order to ensure the adequacy of the rent and the preservation of the asset in good working condition to the end of the lease period, because if the lessee refuses to buy the asset as stipulated by the contract, the bank will have to sell it on the market in order to recover its financial investment.

Other types of risk stem from the fact that the Islamic banking methods of operation, still developing, have not gained a wide following yet, and require greater understanding from the business community. Other risks are connected with the weak moral character of certain customers of Islamic banks and with the lack of ethical business practices in the community. One important factor that may increase the degree of risk, according to an official of the Faisal Islamic Bank of Sudan, is the lack of statistical data such as profit distribution ratios among the parties involved in several trade, industrial, or service investment ventures.[16] The fact that the contractual agreement includes the distribution of profit ratios, while the parties lack experience in this regard, may, after additional facts became known, cause one or the other to feel deprived or that he has been taken advantage of; one of the parties may then resort to inequitable, illegal, or immoral practices in order to retaliate.

Safeguards and Control Measures

The minimization of the risks requires that certain managerial, financial, and legal measures be taken by the Islamic bank in order to safeguard its assets as well as preserve the interests of its shareholders, depositors, and customers. These measures are closely related to each other and may be taken separately or simultaneously. They are discussed here separately for the purpose of clarity.

Managerial measures According to Islamic banking literature, the managers of Islamic banks apply planning and control techniques to the investment program and other activities of the bank. Since management has the power to accept or reject financing proposals, the choice of investment projects is based on a careful study that includes technical, managerial, economic, financial, and social considerations. The parties to the business venture or the contract are investigated and their business acumen and moral character are assessed. Whenever possible, the bank's management is represented on the boards of directors of the companies or firms for whom it provides financial assistance. If that is not possible, the bank reserves the right to intervene or participate in the management decisions of these firms. For example, Article 16 of the IDB Articles of Agreement states that careful attention should be given to the possibility that the recipient of the funds and the guarantor, if any, will be in a position to meet their obligations under the contract. In case of adverse business conditions, or if the funds made available by the bank were used for purposes other than those intended in the contract, appropriate steps will be taken.

If the Islamic bank adopts adequate managerial control and follow-up procedures, its investment risk is minimal. The managerial techniques utilized to minimize the risk, however, may be limited by restrictions imposed by various laws and regulations, the articles of agreement, and resolutions passed by the general assemblies of the banks. Most articles of agreement state that no one shareholder or specific group may own more than a maximum number of shares; this ensures that the bank's investment decisions or other practices are not influenced. Ownership in some banks, such as the Bahrain Islamic Bank and the Kuwait Finance House, is restricted to the nationals of the country in which the bank is located.[17] Other banks do not restrict ownership by nationality, but the laws of the country in which they are located impose restrictions that prohibit more than 49 percent ownership by other nationals, as in the case of the Faisal Islamic Bank of Egypt.[18] Banks that are incorporated in countries other than Islamic countries, such as Dar Al-Maal Al-Islami which operates in Saudi Arabia through its IIC subsidiary, do not impose any nationality restrictions of this kind.[19]

Other examples of restrictions imposed by the banks and stated in the articles of agreement relate to the members of the board of directors. A board member has to own a certain number of shares and comply with certain conditions. The most stringent condition is that the member is not allowed to participate in any business practices that compete with the bank's operations, or create any conflict of interest during the time of his membership, which is limited to a specified number of years.[20]

Financial measures Financial measures taken by Islamic banks to minimize risk include guarantees from the parties who participate in the bank's investment ventures or those who receive loans. These measures also include controls on the flow of funds and specified authorizations for cash withdrawals, purchases, and commitments to the investment projects financed by the bank. The bank may also set a ceiling on the amount of investment certificates sold on the market and/or the amount of funds invested in projects or loaned to customers. For example, Section 14(f) of the Jordan Islamic Bank (JIB) Law restricts the total value of its outstanding bonds of various types to an amount not to exceed five times the bank's paid-up capital. The Islamic Development Bank states in Article 21 of its Articles of Agreement that 'the amount of its equity investments, outstanding loans, and other ordinary operations shall not exceed the amount of its unimpaired subscribed capital, reserves, deposits, and other funds raised and surplus included in ordinary capital resources'.

Most Islamic banks are subject to the restrictions imposed on commercial banks and other businesses either by the banking authorities or the banking laws of the country. For example, Section 15 of the JIB Law requires that the bank conducts its banking activities according to the restrictions applicable to commercial banks, including the maintenance of the required cash reserve, and the percentage of liquidity necessary to maintain the sound position of the bank and to protect the rights of its depositors and shareholders. The JIB is also bound by the instructions issued to other banks which regulate the amount and type of credit and restrict the use of this credit to activities related to the national development of Jordan. On the other hand, the 22 offices of the Islamic Investment Company (IIC) in Saudi Arabia are subject to the Saudi commercial and labor laws, but not to the regulations imposed by SAMA. Since there are no foreign exchange control laws in Saudi Arabia, the IIC is free to transfer funds generated from clients out of the country, but if IIC extends its operations to include commercial banking services it has to be restricted by the Saudi Banking Control Law and the regulations of SAMA. Furthermore, the Islamic Development Bank, whose ownership and operations are different from those of the IIC and other Islamic banks, is not subject to the Saudi Banking Control Law. SAMA, however, has acted as its trustee and depository for the funds received from its subscribers. SAMA even invested these funds in short-term instruments in order to keep them available in liquid form. When the IDB began operations and used the funds in its investment and lending programs, the amount of the funds deposited with SAMA declined substantially. It is important to point out that the Saudi government is a major stockholder and supporter of the IDB operations, and neither SAMA nor any other Saudi regulatory authority interferes in or imposes restrictions or taxes or customs duties on these operations.

Generally speaking, whenever there are exceptions to the banking, commercial, or tax-related laws and regulations, they are specified by the authorities or by the laws governing the establishment of the bank. These exceptions are necessitated by the fact that the nature, objectives, and methods of operation of Islamic banks differ, to a certain extent, from those adopted by conventional banks.

There are other financial and control measures that relate to restrictions on the distribution of a bank's earnings to the shareholders, investment and savings accounts depositors, and holders of investment certificates or bonds. These measures include the establishment of legal reserves imposed by the banking laws or the commercial companies laws. The legal reserve imposed by commercial laws on the Islamic banks operating in the Arab world is 10 percent of the net profit for the year, except for the Faisal Islamic Bank of Sudan where the reserve is set at 15 percent of net profit. Other banks appropriate an additional reserve, which is referred to as the special reserve, capital reserve, or general reserve. Furthermore, in accordance with the generally accepted accounting practices of the country in which the bank is located, all of the Islamic banks make allowances for depreciation and establish a provision for bad debt. Some banks have established allowances for investment risk. The Jordan Islamic Bank has moved in this direction, and the reserves appropriated by the Nasser Social Bank, such as the reserve invested in commercial paper, the reserve for financing investment projects, the reserve for guaranteeing deposit accounts payments, and the reserve for general price increases, accomplish the same purpose.

In addition to investments, foreign trade, and other bank activities, several Islamic banks have either established or are in the process of establishing subsidiary insurance companies. These subsidiaries provide needed investment protection, on the basis of the principles of cooperative insurance, which is in accordance with the Islamic Shariah. The insurance services offered by these subsidiary companies include marine, air, fire, motor, and engineering insurance. The services are not only provided for the protection and security of the property of the Islamic banks but are also made available to other businesses and to the general public.

Finally, the financial statements of Islamic banks, like the financial statements of other businesses organized under the laws of incorporation, are subject to audit by statutory or certified independent accountants. The audit by this independent third party professional provides an added safeguard for the shareholders, investors, and savings depositors who have entrusted the bank management with their cash funds. The safeguard is derived from the fact that the auditor renders an opinion in the audit report attesting to the 'fairness' of the bank's financial position at the end of the year, and the results of its operations and the changes in the financial position for the year just ended, in conformity with the generally accepted accounting principles applied on a basis consistent with that of the preceding year. Any exception to these principles and any violation of the articles of agreement of the bank normally are reported in the audit report. The auditor's opinion adds to the reliability and credibility

of the overall data included in the financial statements. The problem is that in the developing world where the Islamic banks operate the accounting profession suffers from a number of weaknesses. Usually, certified accountants are licensed by the Ministry of Commerce, such as is the case in Saudi Arabia, if they meet certain requirements, the most important of which is a college education in the field of accounting or business and work experience in an auditing office. These requirements differ from those applied in the advanced industrialized countries where the certified accountant must have passed a comprehensive examination which covers accounting principles and practices, auditing standards and procedures, the code of professional ethics, taxation, and commercial law. Knowledge of other subject areas such as computers, mathematics, and organizational behavior may be required because they are considered important for the fulfilment of the auditor's professional responsibilities. In most of the developing countries this examination is not required for certification because there are no formalized principles and standards and because these countries suffer from a lack of qualified accountants and weak accounting educational curricula.

The lack of effective auditing standards and procedures in Saudi Arabia and in other countries where Islamic banks are located does not imply that the Islamic bank auditors' reports are not reliable. They are reliable in the superficial sense that they attest to the fact that the bank's financial practices conform to the laws of the country where the bank is located and to the articles of agreement. The auditors are appointed by the general assembly of the shareholders, and in some cases – for example, the Faisal Islamic Bank of Egypt – two or more auditing firms are appointed to perform the audit. Where more than one auditor is appointed confidence in the auditors' opinion is enhanced because, supposedly, each will perform the audit independently. Furthermore, the appointment of auditors to audit the accounts of the enterprises receiving financial assistance from the banks is an important responsibility. If the banks are given the authority to choose auditors for these enterprises they feel a greater sense of security.

Legal measures The viability and growth of Islamic banks depend, to a great extent, on the earnings resulting from the use of the available funds in their operations. However, it was indicated earlier that profit realization is accidental in this framework, and the ultimate objective is the social good of the country and not the direct return to the bank itself. This means that stability and growth become the overriding factors and the main criteria used in the evaluation of the performance of Islamic banks. The point is that these banks cannot afford delayed payments or defaults, or they experience drastic miscalculation of the profitability of their investment ventures. In commercial banking, whenever the bank encounters payment delays and defaults, it resorts to the use of the interest rate weapon in order to obtain compensation. The

Islamic banks are deprived of the use of this weapon to bring pressure on delinquent clients and borrowers.

The Islamic banks are not explicit in their articles of agreement about the penalties imposed on delinquent borrowers, but it is implied that in cases of delays and defaults the bank will resort to the legal system of the country in which it is located. The commercial laws covering contracts in the country shall prevail. The Islamic banks, like other banks or business and financial organizations, specify in their by-laws that their contracts should state the details of means available to obtain repayment of the bank's investment with related profit, if any. For example, Article 63 of the Dubai Islamic Bank Articles of Association specifies that the bank may obtain payment by 'direct collection of the concerned project income'. This statment implies that the bank has the legal right to claim amounts due from the project. The Islamic Development Bank stipulates in Article 20 of its Articles of Agreement that if the country receiving loans from the bank suffers from acute foreign exchange stringency and cannot fulfil its contractual obligations, the IDB may modify the terms if the circumstances justify a modification. However, the bank will also levy a service fee to cover its administrative expenses. In addition, according to Article 44 of the IDB Articles of Agreement, the bank may suspend the membership of a participating country for 1 year if the member fails to fulfil its obligation to the bank. The nation whose membership is suspended is not entitled to exercise any rights under the Articles of Agreement but shall remain subject to all its obligations.

Most Islamic banks hire Islamic law experts as consultants to advise them on the legal, doctrinal basis for action to be taken on defaults and other matters related to incidents that cause a loss on the investment. It is not enough that the laws and regulations of the country be applied; action on the part of the bank has also to be in compliance with the Shariah. Deterrent punishments, which may include confiscation of property or blacklisting by all Islamic banks, may be legal but not necessarily compatible with the Shariah.

With respect to the issue of dealing with stockholders, the articles of agreement of each bank are clear on the action that the bank may take if a stock subscriber fails to pay his share instalments on time. The bank normally gives the shareholder adequate time to make the payment, after which it may auction the stock certificate under the prevailing laws of the country. In addition, any shareholder has the right to institute proceedings against the board of directors in the case of any wrongdoings on the part of any of its members. Usually a meeting of the general assembly will be arranged to settle the dispute.

In conclusion, the legal measures to reduce the risk taken by the owners and investment depositors, individually or collectively, vis-à-vis each other or vis-à-vis a third party, are available and provide adequate deterrents. These legal measures, along with various managerial and financial measures, have been critical in the emergence of the new and developing Islamic banking system.

BANKING AND SOCIAL SERVICES

Banking Services

The banking services offered by the Islamic banks, including the ones operating in Saudi Arabia, are similar to those offered by commercial banks in general, with the exception of making loans or accepting deposits at fixed or varying rates of interest. Only the banking services offered by the Saudi-based Islamic Development Bank differ substantially, because of the IDB orientation towards development loans, equity participation, developmental commodities financing, and special and trust funds.

Islamic bank services are grouped into the following categories: (1) current accounts; (2) savings accounts; (3) investment accounts; (4) investment certificates or bonds; (5) loans, other than beneficial loans (Kard Al-Hasan); (6) transfers, collections, and guarantees; and (7) other services. These services are offered either for a fee or on the basis of administrative cost and expense recovery. Investment services which are included above in savings accounts, investment accounts, and investment certificates or bonds are offered on the understanding that investment deposits may be added to the bank's own funds for the purpose of participating in various investment projects.

Current Accounts

Current accounts, which are sometimes referred to as checking accounts, are payable on demand. They are accepted in foreign currencies or may be limited to the currency of the country in which the bank is located. The funds deposited in these accounts may be used by the bank in its financial activities. Current accounts are considered by the Islamic banks to be a service offered to the customer, free of charge, and no interest or profit is paid to the depositors on these accounts. The two Islamic banks which operate in Saudi Arabia, the IDB and the IIC, do not offer the current accounts service because they are not licensed by SAMA and are not considered to be commercial banks.

Savings Accounts

Savings accounts are offered as a banking service free of charge. There is no minimum amount set for these accounts, and the savings deposit balance could be withdrawn by the customer in its entirety or in parts at any time. The bank usually carries these accounts without authorization to invest balances in the bank investment ventures or projects. However, while in some banks all or part of the savings account deposits are invested along with other funds, they are

allotted a lower profit rate than the investment accounts because of the short-range nature of the projects the funds are allocated to and because the deposits can be withdrawn at any time. This latter type of savings account is available in Saudi Arabia at the IIC offices where it is called 'Modarabah Number Four'; funds can be withdrawn within a few days. The IIC, however, charges a fee at the time the deposit is made and pays a dividend on the savings account balance.

Investment Accounts

The Islamic banks accept deposits in the form of investment accounts, and invest the deposited funds on behalf of the depositors in economic sectors or projects whose operations conform to Islamic principles. The investment deposits are entitled to a portion of the return on investment according to the amount of the deposit and the time involved. For this reason, the investment accounts are grouped into limited period and unlimited period investment deposits. The limited period investment deposits, which are sometimes called 'notice investment deposits', could run for the duration of 3, 6, 9, or 12 months. The unlimited period deposits are called 'fixed-term deposits' and run for durations of 1 year or more and may be renewed upon notice. Islamic banks differ in their practice of accepting investment deposits for a certain time period. The Kuwait Finance House, for example, accepts investment accounts for a period of not less than 1 year. Other banks, such as the Faisal Islamic Bank of Egypt and the Faisal Islamic Bank of Sudan, accept investment deposits for any period of time. These differences stem mainly from the nature of the projects the banks are engaged in.

The bank usually allocates a higher percentage of profit to the savings and investment accounts if the deposit period is longer. This is due to the fact that the bank invests a smaller percentage of the amount deposited if the period is less. For example, the investment participation of the amount of deposit in the Jordan Islamic Bank is specified to be 50 percent on the savings accounts, 70 percent on the notice accounts, and 90 percent on the fixed-term accounts. The Islamic banks also vary in profit distribution policy and practice. To be entitled to profit the deposit has to be held for at least 1 month in the case of the Faisal Islamic Bank of Egypt, 3 months in the case of the Faisal Islamic Bank of Sudan, and 1 year in the case of the Dubai Islamic Bank. Other banks do not specify any minimum period, but they offer depositors different options of specified periods. The investment account option is available in Saudi Arabia through the IIC offices which offer these accounts in different currencies and pay a dividend if the amount of the deposit is held for not less than 1 year. In general, the bank enters the investment market as a Modareb with the depositors, and for this reason it allocates a certain percentage of the total profit on the investment to its reserve (between 10 and 20 percent) to recover its administrative expenses, and distributes the remainder to the depositors.

Investment Certificates or Bonds

The various Islamic banks introduced to the market under different names a new approach to investment. The names are 'investment Modarabah certificates', 'investment deposit certificates', 'Muquaradah bonds', and 'profit-sharing investment certificates'. In Saudi Arabia, the Modarabah certificates are issued by the Islamic Investment Company and the investment deposit certificates are issued by the Islamic Development Bank. The Jordan Islamic Bank and the Bahrain Islamic Bank are authorized to issue Muquaradah bonds and profit-sharing investment certificates respectively; however, there is no indication that these bonds and certificates have been issued.

The Modarabah certificates of the IIC are issued to the public for different maturity periods, with varying estimated profit rates. In addition, the IIC issues Islamic Modarabahs for banks and financial institutions, for governments, and for other Islamic banks and institutions. These latter Modarabah certificates have larger values and are issued for a shorter period of time. In all cases, the longer-period certificates earn a higher return. One of the certificates is called 'Modarabah for investment, savings, and mutual assistance'. According to the IIC, this Modarabah provides an Islamic alternative to Western-style life insurance. The main attraction of this Modarabah is that the subscriber receives at the end of its 20-year term all instalments he has already paid, together with profits. If he dies in the meantime, his heirs receive the amount of all paid and unpaid instalments and accumulated profits. The reasoning behind this Modarabah is that all subscribers join in paying the rest of the instalments which the subscriber would have paid if he had lived. The other certificate available in Saudi Arabia is the investment deposit certificate issued by the IDB to individuals and firms in a minimum amount of US$250 000. The funds generated from the issuance of this certificate are invested exclusively in foreign trade financing operations and the return from these operations is distributed among depositors.

The Muquaradah bonds issued by the Jordan Islamic Bank are either joint or particular Muquaradah bonds. The joint Muquaradah bonds have a fixed term, which does not exceed 10 years, thus providing a specified date of maturity. The particular Muquaradah bonds relate to a specific project or particular purpose, and are subject to gradual repayment in accordance with the income desired from the project (or projects) which is financed by the proceeds of each separate Muquaradah bond issue. The joint Muquaradah bonds participate, on a percentage basis, in the total net profits from investment for every financial year following the year of their issue, and in accordance with terms and conditions set for each issue separately. On the other hand, the particular Muquaradah bonds are allotted a share of the net income of the project in which they are invested, which is calculated separately from the net income related to joint investment. The profit-sharing investment certificate is an option given by the Bahrain Islamic Bank in its Articles of Association. The certificates are negotiable between customers of the bank and in the stock market.

Loans, Other than Beneficial Loans

Islamic banks do not offer loans like those offered by conventional commercial banks. The loans offered by the Islamic banks do not carry interest charges and they have different forms and purposes. This section details the general nature of these loans and their economic and financial aspects.

Islamic banks may offer loans in return for adequate guarantees of repayment, and they may receive a service charge that covers their administrative costs and expenses. However, there are several objections to this practice from an Islamic and general economic point of view. Islam does not inhibit the circulation of money capital through loans because there is no objection to earning profit on capital. Furthermore, the practice of merely recovering the administrative costs of loans is not feasible because it makes the cost of capital very low, which as a consequence may not be allocated efficiently, particularly in a country where capital is scarce. From the point of view of financial administration this practice is confined to government financial institutions, such as the funding agencies in Saudi Arabia. Private sector financial institutions would have no incentive to lend using this method because neither the stockholders nor the savings and investment depositors would obtain any return on the funds they made available. In an economy where inflation is chronic depositors seek to protect their savings and make a return to cover at least the rate of inflation in order to retain the purchasing power of their savings. When depositors do not receive any return on their deposits they lose some of the purchasing power of the money deposited, and the only benefit they derive from the transaction is their savings' safety.

The practice of recovering administrative costs and expenses on loans seems to be contrary to the principles of Islam because businessmen who are in need of capital funds would be the beneficiaries of low-cost loans and the savers would gain nothing. As a result, borrowers would dominate the financial and business markets and become wealthier, and the savers, particularly the poor ones with inadequate savings to start a business, would become poorer.

Loans are made by the Islamic banks for social or developmental purposes, particularly by those banks that are owned or primarily owned by governments. For example, the Nasser Social Bank of Egypt provides loans free of interest charges for university education, pilgrimage (hajj), and other social purposes. The Islamic Development Bank also offers loans to the private and public sectors for financing productive projects, enterprises, and programs in its member countries. Article 18 of the bank's Articles of Agreement states that 'in making loans for specific infrastructure and other projects, the Bank shall take into account each project's potential return and importance in the scheme of priorities of the recipient country'. Article 19 also states that 'in making programme-loans to member countries, including institutions or agencies thereof, the Bank shall satisfy itself that the purpose of the loans is to promote the wellbeing of the people through economic and social development'. These loans, whether they are project or program loans, are regulated by the setting of terms and conditions that guarantee their proper handling. Article 20 states:

(1) The Bank shall determine the schedule of repayment of loans extended under Articles 18 and 19 bearing in mind relevant considerations, especially the overall resource position and the balance of payments prospects of the member country concerned.
(2) If a member represents that it suffers from an acute foreign exchange stringency and that the service of any laon contracted or guaranteed by that member or any of its agencies cannot be provided in the stipulated manner, the Bank may at its discretion modify the terms of amortization or extend the life of the loan or both provided that it is satisfied that such relaxation is justified in the interest of the particular recipient and the operations of the Bank.
(3) The Bank shall levy a service fee to cover its administrative expenses. The amount of the fee and the manner of levying it shall be determined by the Bank.

According to Article 21, the IDB recognizes certain limitations on the total amount of loans, equity investments, and other ordinary operations, which shall not 'exceed the total amount of the unimpaired subscribed capital, reserves, deposits, other funds raised, and surplus included in Ordinary Capital Resources'. The IDB granted 46 loans to 29 countries, totalling US$310.13 millions, between 1396 AH (1976) and the end of 1402 AH (1982).[21] This constitutes approximately 35.3 percent of the total project financing offered by the bank during the same period. These loans finance, for example, the extension and development of a research center, the construction of a training center and a vaccine and serum center, and facilities for the technical training of personnel in developing countries. Other examples include the construction of an electrical interconnector over a river across a distance of 8.3 miles and between the Eastern and Western Zones of Bangladesh, the development and financing of laboratory equipment for science education in 640 schools in Lebanon, the construction of a dam in Morocco, financing foreign exchange requirements for a water supply system in Yemen, and partial foreign exchange financing for an irrigation project in Mauritania. The most recent examples (1981 and 1982) include the IDB participation with several development funds in financing construction projects such as dams, roads, power plants, and technical education facilities in 16 developing countries.

Other Islamic banks, including the Jordan Islamic Bank, offer short-term loans as a service without interest, either by discounting commercial short-term promissory notes or by instalment lending. The Kuwait Finance House Memorandum of Agreement, Article 6, includes in its banking services provision of 'short-term financing against collateral in the form of commercial papers and at an agreed commercial yield not involving usury'.

It is important to note that the articles of agreement of the Islamic banks and their annual reports state that the banks offer limited short-term loans under guaranteed securities, notes, or other collateral, but they explicitly state that

no interest will be involved in the transaction. This does not mean that the bank is going to take excessive risk and does not benefit from lending transactions. The bank will take a service fee for handling the loan, the amount of which depends on the bank's expenses and is not necessarily related to the amount or the length of the loan period. The Faisal Islamic Bank of Sudan makes it clear that it grants only social service beneficial loans (Kard Al-Hasan), discussed below.

Transfers, Collections, and Guarantees

The Islamic banks offer normal banking services to their customers through other Islamic banks or through their correspondent banks. These services include domestic and international transfers, the collection of bills of exchange, letters of credit, letters of guarantee, travellers' checks, purchase and sale of foreign currencies based on spot rate, and purchase and sale of gold and other precious metals. These services are essential for the bank's customers, and they are offered for a fee that contributes to the recovery of the bank's overhead expenses and profits.

Banking and Financial Advisory Services

Banking and financial advisory services offered by Islamic banks include safe deposit services, property management, consulting services and preparation of feasibility and other studies, receipt and sale of stock subscriptions to other companies, purchase and sale of stocks on behalf of other companies or third parties, and credit card services. These services may also include acting as a trustee in accordance with the Islamic Shariah and other laws in cooperation with the competent religious body of the country in which the bank operates. These services may not be essential to most customers but they widen the scope of services offered to the public, providing a positive image of Islamic banking. The number and extent of the services offered depend on the bank's size and experience, the frequency of the requests for these services, and other matters related to the management of the bank and the laws of the country in which it is located.

Social Services

The social services offered by the Islamic banks are categorized as follows: (1) beneficial loans (Kard Al-Hasan), (2) funds for social purposes, (3) Zakat and donations, and (4) other social services.

It is important at this stage to remember that the original idea of Islamic banking was to foster social change in Islamic communities. Economic and social developments are not separate endeavors, and the social services offered by the Islamic banks are not looked upon as charity or donations by those who

are in need of funds. On the contrary, the banks are looked upon by the recipients as support agents who will improve their ability to produce and contribute to the economic and social wellbeing of their communities.

Beneficial Loans (Kard Al-Hasan)

Beneficial loans are referred to as 'out of goodness loans' because the bank does not expect any direct return when these loans are made. Beneficial loans are made for productive purposes in various fields in order to help the beneficiaries to start independent lives and to raise their standard of living. Dubai Islamic Bank, for example, provides shareholders and depositors with loans free of any interest. The DIB calls these loans 'good faith loans' and, according to Article 66 of its Articles of Agreement, offers them under the following conditions:

(1) when economic and legal considerations associated with the transaction as it affects the bank and the borrower are satisfied;
(2) when securities, guarantees, and other stipulations, excluding the profit sharing stipulation are satisfied;
(3) when the loan is granted for the purpose of production and not consumption;
(4) if the amount of the loan is small as decided by the board of directors who sets the relative limits of the loan; and
(5) if the loan is a short-term loan as determined by the board of directors who sets the maximum period of the loan.

The Islamic Bank Conference, held in Dubai in 1979, considered the bank overdraft as equivalent to Kard Al-Hasan. It was decided in the conference that it does not contradict the Islamic Shariah if some banks allow an overdraft to certain customers for a short time and without any interest or expense charges. It was added that the Islamic Shariah favors helping those in need to withdraw more funds than they have at the bank, and if the bank consents to this practice then the overdraft might be looked upon as the same as Kard Al-Hasan.[22]

Funds for Social Purposes

Islamic banks may establish and administer special funds for various worthy social purposes. Normally these funds will have independent management, and their accounting will be separate from the accounting of the other operations of the bank. Charities in the form of grants and donations are accepted from shareholders, depositors, or other parties, and will be spent in accordance with the Shariah. Each fund will have its own committee whose members will be selected by the board of the bank from the shareholders, depositors, and other donors to the fund, and they will serve for a certain period of time. The bank

also sets certain rules for the management of the fund which may include rules on the investment of the funds in specified ventures or projects. The Islamic bank may receive a certain percentage of the profits realized by the various funds, or it may charge the funds with the costs and expenses which it incurs when performing services on behalf of the fund.

This service is offered by almost all the existing Islamic banks including the Islamic Development Bank; however there is no evidence in the annual reports of these banks that this practice has gained acceptance as yet. Nevertheless, there is evidence that some banks have set up their own special funds for social, relief, or scientific purposes. For example, the balance of the IDB special assistance account amounted to 144.88 million Islamic dinars (US$155.5 million) at the end of 1402 AH (1982), 30 percent of which has been allocated to special assistance funds including those for the Islamic Research and Training Institute, relief against natural disasters and calamities, technical assistance, and other Islamic causes.[23] The special assistance operations include aid to war refugees in Cameroon, Afghanistan, Malaysia, Somalia, Cambodia, Eritrea; and to flood or earthquake victims in Algeria and Yemen. There is also educational assistance to schools and colleges in Occupied Palestine, Cyprus, Vietnam, Sri Lanka, Togo, Sierra Leone; and special assistance for construction of mosques in Kampochea. The IDB does not limit its provision of these social services to member countries, but it extends them to Muslim communities in non-member countries as well.[24]

The other Islamic bank that made special allocation for this type of service was the Kuwait Finance House, which allocated to the Kuwait Institute for Scientific Advancement 5 percent of its annual net profit after deduction of the statutory reserve and the deduction of dividends to savings and investment depositors. The amount allocated to the institute in 1982 alone was KD 419 505, about US$1.4 million.

Zakat and Donations

Most Islamic banks have special departments which accept Zakat from individuals or organizations and distribute it on their behalf in accordance with the Islamic Shariah. The banks also may deduct any amount of Zakat from the accounts of the customers if authorization is given to the management. In addition, the banks distribute Zakat due on their own net worth. The amount of Zakat may be paid to the Zakat fund of the country which is distributed by the government to the deserving individuals stipulated in the Qur'an or may be paid to these individuals directly by the banks. In Saudi Arabia half of the due amount of the Zakat should be paid to the National Zakat Fund, and the other half may be distributed by the person or the organization concerned. In Egypt, the due Zakat on the bank's net worth may go to the Zakat fund set up by the bank itself. The Zakat fund of the Nasser Social Bank, which is shown separately from the bank's accounts, experienced substantial growth over the years. The sources of the Zakat fund increased by 61 percent in 1979,

19 percent in 1980, and 29 percent in 1981, reaching 1.14 million Egyptian pounds, about US$1.62 million, on 30 June 1981.[15] This amount represents cash in bank, commercial papers, investments, and Zakat in kind given by individuals. The Dubai Islamic Bank shows a substantial increase in the Zakat distributed since the establishment of the bank in 1976.[16] The Zakat proposed for distribution in 1981 was double that of 1980, reaching 500 000 UAE dirham, about US$136 200. Other banks show Zakat funds in their annual reports, but most probably the balance of these funds represents the Zakat due on their own operations. The amount of the Zakat fund becomes larger, then, when the people rely on the bank to distribute their own Zakat to the poor and other deserving individuals.

There is no uniformity in the method of calculation of the Zakat due on the banks' operations, and in several cases the statements do not show any calculation at all. This is true for the annual reports of the Jordan Islamic Bank and the Bahrain Islamic Bank. The Zakat tax may have been considered to be an expense and its amount included in the total expenses of the banks. This eventually makes it difficult to draw any conclusion concerning the conformity of the Zakat allotment to the Shariah and the effectiveness of the religious supervisory boards of the Islamic banks.

Other Social Services

Other services offered by the Islamic banks include cooperation with other local and international organizations for the purpose of promoting social, religious, and economic objectives. For example, the IDB cooperates with cultural, scientific, educational, health, and various economic institutions connected with the United Nations. Other Islamic banks also cooperate with each other as well as with local, regional, or international agencies or organizations for the purpose of reinforcing their efforts in the pursuit of their objectives. For example, the Dubai Islamic Bank recently joined the Dubai Cooperative Organization in a project to ensure that imported meat was slaughtered in accordance with Shariah instructions. The DIB signed an agreement with a Danish corporation through which the DIB will send representatives to Denmark to supervise the slaughtering operation, performed by Muslim workers. A similar agreement is being reached with slaughtering houses in France and England. The Dubai Cooperative Organization and the DIB will have their own emblem identifying the packaging in which the imported meat is transported.[17] The Saudi Arabian *Al-Riyadh Newspaper*, which published the news of the arrangements, also published a commentary advocating the adoption of a similar practice in Saudi Arabia. The Kuwait Finance House completed in 1982 a Musharakah agreement with a local business firm to import frozen chicken to be sold in the Kuwaiti markets at reasonable prices. The frozen chicken carry an emblem indicating that slaughtering according to the Islamic Shariah was supervised by KFH. The effort of Islamic banks to help Muslim countries adhere to their religious beliefs and practices improves their image,

and enables them to identify more effectively with the Muslim communities they serve and in which they operate.

DISCUSSION QUESTIONS

7.1 Identify the major income-generating sources of the Islamic banks.
7.2 Briefly explain the investment activities permitted by the Islamic Shariah.
7.3 How does the Musharakah differ from the Modarabah investment method? Discuss.
7.4 What is the justification for the profit taken by the bank in the Murabahah form of Islamic investment? Why is Murabahah confused with financing through a fixed interest rate? Explain.
7.5 Why is the profit taken by the bank in the Murabahah method popular in developing inter-Islamic trade? What is the main reason for the popularity of this investment method? Explain.
7.6 Leasing, as practised by Islamic banks, does not involve interest. Why? Explain.
7.7 Explain and evaluate the degree of risk taken by Islamic banks in each of the investment methods permitted by the Islamic Shariah.
7.8 According to an official of the Faisal Islamic Bank of Sudan, one important factor that may increase the degree of risk in Islamic banking methods of operation is the lack of statistical data. Explain.
7.9 Briefly explain the control measures taken by Islamic banks in order to safeguard assets and preserve the interest of the shareholders.
7.10 There are certain shareownership and board of directors membership restrictions imposed by the banks' articles of agreement, or the laws and regulations of the country in which Islamic banks are located. What are the reasons for these restrictions? Discuss.
7.11 Evaluate the financial measures taken by Islamic banks to minimize investment risks and protect depositors and shareholders.
7.12 Explain the financial and control measures imposed on Islamic banks by banking laws or banking authorities in some countries where the banks are located.
7.13 Legal reserves, voluntary allowances, and special reserves are considered appropriate measures for the protection of depositors and shareholders. Do you agree? Why?
7.14 The independent auditor's opinion adds to the reliability and credibility of the overall data reported in the financial statements of Islamic banks. Discuss.
7.15 What are the legal measures available to Islamic banks in the case of defaults or payment delays by customers? Does the measure have to comply with the laws of the country in which the bank is located or does it have to comply with the Shariah? Explain.
7.16 Are the banking services offered by Islamic banks similar to those offered by conventional banks? Explain.

7.17 Explain the differences between the various types of accounts available to Islamic bank depositors.
7.18 Explain the nature and economic feasibility of the type of loans offered by Islamic banks. Do these loans differ from those offered by conventional banks?
7.19 What are the social services offered by Islamic banks? Discuss.
7.20 It is difficult to draw any conclusion concerning the Islamic banks' compliance with the Shariah in making their Zakat allotment. Why?
7.21 State and explain the 'other social services' offered by Islamic banks.

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CHAPTER 8

Islamic Banks: Past Performance and Future Prospects

INTRODUCTION

An assessment of the past performance of the Islamic banks offers an indication of their potential in the future. An analysis of the financial statements is made for the purpose of assessing and comparing the financial positions and results of operations of the banks. However, this task is complicated by the fact that uniformity of accounting policies is necessary for meaningful assessment and comparison of the financial data, yet the banks under discussion have adopted different policies. This chapter covers the following major topics: (1) accounting policies, (2) growth, (3) utilization of funds, (4) profitability analysis, (5) evaluation of DMI performance, and (6) the prospects for Islamic banking. The major topics are dealt with on the basis of findings in the literature, the articles of agreement, and the annual reports of the banks. Even though there are several Islamic banks in operation, this study is confined to the following, whose annual reports were made available to the authors:

(1) Nasser Social Bank
(2) Dubai Islamic Bank
(3) Islamic Development Bank
(4) Kuwait Finance House
(5) Faisal Islamic Bank of Egypt
(6) Faisal Islamic Bank of Sudan
(7) Jordan Islamic Bank
(8) Bahrain Islamic Bank

The financial data extracted from the reports of the above-mentioned banks are for the years 1978–1982. However, three of the eight banks, the Islamic Development Bank, the Faisal Islamic Bank of Egypt, and the Bahrain Islamic Bank, report the results of their operations at the end of the hijra year, using the Islamic calendar. The ends of the hijra years 1398, 1399, 1400, 1401, and 1402 correspond to 30 November 1978, 19 November 1979, 8 November 1980, 27 October 1981, and 17 October 1982 (see Appendix E).

ACCOUNTING POLICIES

The accounting policies discussed here relate to the recording of (1) assets and liabilities, and (2) the calculation of profit.

Recording Assets and Liabilities

All Islamic banks follow the historical cost principle where the actual costs, cash or equivalent outlay, of acquired assets are recorded in the accounts. Islamic banks do not follow a uniform policy in recording depreciation write-off over the expected useful life of similar fixed assets. For example, the Bahrain Islamic Bank writes off the cost of its fixtures, office furniture, and office equipment in equal instalments over a 5-year period, and the costs of fixed properties are treated as trading assets and, accordingly, are not depreciated. The Jordan Islamic Bank, however, writes off the cost of its fixed assets using a 1.5 percent rate for buildings, 6 percent for furniture, 10 percent for machinery and equipment, and 15 percent for automobiles. The Faisal Islamic Bank of Sudan does not depreciate its buildings, and the other Islamic banks do not show which method is used in depreciating their fixed assets.

As a general rule, investments are valued by Islamic banks at cost. However, the Bahrain Islamic Bank values securities using the conservative method of the lower of cost or market. It also values its investment in gold, silver, and other commodities in accordance with rates ruling on the New York Stock Exchange. The Kuwait Finance House values its stocks (inventories) at the lower of cost and the net realizable value method, with due allowance for slow-moving items.

Assets and liabilities in foreign currency normally are shown at the rates of exchange ruling on the balance sheet dates, and any resulting gains and losses are taken to the income account. However, the Faisal Islamic Bank of Sudan values its foreign currency balances and foreign cash at the middle rate ruling at the end of the year as quoted by the Central Bank of Sudan. The Faisal Islamic Bank of Egypt values its assets, liabilities, revenues, and expenses in currencies other than the US dollar (the monetary unit adopted by the bank) at a fixed rate of exchange equal to 71.4 Egyptian piasters without income recognition from the valuation of currency whenever their market rates change at the end of the year. The Islamic Development Bank, however, values its assets and liabilities by translating them from various currencies on the basis of the Islamic dinar, according to the rates declared by the International Monetary Fund at the date of the balance sheet. The net difference resulting from the translation of currencies into the Islamic dinar is carried to a special reserve account. In summary, the policies governing the practices of recording asset and liability items and the balance sheet presentation of these items are rather conservative and far from being uniform for all Islamic banks.

Calculation of Profit

The importance of the selection of accounting methods to be used in the calculation of revenues and expenses is emphasized here because of the effect of the measurement of profit and profit distribution to the different categories of suppliers of funds. The accounting policies adopted by Islamic banks are quite conservative because they report the lowest of several possible values of assets and revenues and because they report revenues later rather than sooner.

In addition, these accounting policies are not uniformly applied by Islamic banks. For example, the difference in currency valuation at the end of the year is carried to the profit and loss statement in all banks, with the exception of the Islamic Development Bank which carries it to a special reserve account on the balance sheet. Furthermore, the generally accepted accounting practices followed in most countries where Islamic banks are located include the accrual method of accounting for revenues and expenses in the preparation of the profit and loss statement. However, an examination of the annual reports of the Islamic banks reveals deviations of this method. The Kuwait Finance House calculates income from construction contracts by recognition of such income on the completed contract basis. Profits derived from uncompleted contracts on the date of the statement are not included in the income on the basis of the percentage of completion method. This practice is not in conformity with the accrual method where profits are recognized on the basis of partial performance if their estimation can be made with reasonable accuracy and if ultimate realization is reasonably assured. In addition, profits arising from all sales of property are included in income at the date of sale regardless of whether the sale was made on a credit or cash basis.

The income derived from financing and joint investment activities is calculated separately in order to account for proper distribution to savings and investment depositors, and income derived from investments for specific purposes has to be calculated by accounting for revenues and expenses in a separate account for each particular project. Also, the bank's share of such income has to be added to income from other sources for eventual distribution to shareholders. The Faisal Islamic Bank of Sudan calculates revenues derived from investments and joint ventures on an actual basis after the operation is fully liquidated and the results ascertained. Other revenues are calculated in the same manner. Expenses also are calculated on an actual basis, a practice which does not conform to the accrual basis of accounting.

The Jordan Islamic Bank confirms, in Section 19 of its Law, that it may not adopt a method of accounting which takes into account estimated or expected profits but rather must confine itself to profits realized from the operations which the bank finances. This practice implies the use of different methods of accounting for profits from those for investments. In the case of the individual Modarabah, the profits are realized on the basis of a financial settlement of accounts. An actual receipt of cash is necessary for the realization of income in

the year of settlement, or partial completion, of a project. On the other hand, in the case of decreasing participation, the profit or income is realized on the basis of the net income derived from the project at the end of the financial year. Income realized would be treated as money due but not received.

When the project involves purchase of goods for others (Murabahah), the profit is realized upon the conclusion of the subsequent contract and on the basis of the difference between the actual cost and the price agreed upon with the party making the purchase. The Jordan Islamic Bank in its 1980 annual report presented two points of view for accounting for the profit from Murabahah. The first view, according to Section 19 of the bank's Law, states that 'in the case of purchasing for others on a pre-agreed profit basis, the profit or income shall be realised upon the conclusion of the subsequent contract and on the basis of the differences between the actual cost and the price agreed upon with the party who ordered the purchase'. As a result of this view, profits realized from Murabahah transactions can be distributed even if the amount of revenue from the transaction (the original amount of capital invested plus the profit) has not been received by the bank.

The second view, adopted by the majority of the members of the Jordan Islamic Bank board of directors, took into consideration the revenue collection in the recognition of profit. In other words, profits are recognized during the accounting period on the basis of the cash collected during the period from the party making the purchase, and the profit related to the uncollected amount is delayed for subsequent periods. While this practice is acceptable from an accounting point of view it is not in agreement with the bank's Law. The board referred the case to the Shariah Supervisory Board which approved both points of view but preferred to comply with the Bank's Law. The JIB board of directors referred the case also to the Central Bank of Jordan to ensure legal compliance with the banking laws and practices. The Central Bank of Jordan approved the first view where realization of revenue is recognized upon completion of the Murabahah transaction.

Section 19 of the JIB Law also specified that the various financing operations shall be charged with all the direct expenses and costs arising therefrom, and should not be charged with any part of the general overhead expenses of the bank. This is a logical practice because it avoids the complication of overhead allocation and it is also reasonable because the bank receives a certain percentage of profits made by financing operations the sources of which are the savings and investment accounts. However, this percentage should be adequate to cover the general overhead expenses of the bank.

In summary, accounting practices of the Islamic banks, including the format of the financial statements and the contents of the auditors' reports, are not uniform. Evaluation of risk by time depositors and shareholders could be strengthened if rates of return on investment and other evaluation measures are based on financial data calculated according to uniform accounting policies. The value of such measures as they relate to different Islamic banks could be

enhanced if all banks adopted uniform, or nearly uniform, accounting practices, as long as the nature of the transactions handled and the conditions in the banks were similar.

The disparate nature of the accounting policies used by the Islamic banks should be taken into account in an analysis of financial conditions, growth, and profitability assessment. The degree of reliability of data for assessing the performance or financial condition of each bank is quite high, but for comparison between banks this reliability is weakened because of the inconsistency in the basis of calculation. This is more significant in comparisons of profitability than in analyses of financial condition and growth.

ISLAMIC BANKING GROWTH

The growth and financial strength of the Islamic banks are measured in terms of the increase in assets financed by funds available from current and time depositors and from shareholders as well as from funds generated from operations and retained by the banks. The analysis of the growth of the eight Islamic banks included in this study covers the following: (1) deposit growth, (2) equity growth, (3) asset growth, and (4) structural analysis of deposits, equity, and assets.

The financial data that appear in the annual reports of the banks are stated in different currencies, depending on the location or the policy adopted by the bank. However, to provide meaningful comparisons and to show the extent of the size of the operations of the eight banks, it is necessary to use a common currency. The different currencies are converted into US dollars based on year-end International Monetary Fund exchange rates. As a result, exchange rate fluctuations can have a considerable impact on the rates of growth, as expressed in dollars, in the financial indicators for some of the banks, especially the Faisal Islamic Bank of Sudan, the Jordan Islamic Bank, and the Islamic Development Bank. The root of this problem is found in the relatively substantial dollar exchange movements during the years of analysis for this study.

Deposit Growth

Basically, the deposits of the Islamic banks include current accounts, savings accounts, and time deposit accounts. It is important to reiterate that as a general rule the funds generated from savings accounts and the time deposit accounts are used to finance various profit-earning investment projects, and the funds generated from the current accounts are not used in the activities of the bank without the consent of the depositors. While different bank definitions are applied to time deposit accounts, these deposits include investment accounts, notice accounts, fixed accounts, limited and unlimited period deposits, investment certificates, and investment bonds. As shown in Table 8.1, during 1979 the total deposits for the eight banks increased 135 percent over the

1978 total, and the 1980 total increased 115 percent over that for 1979. However, in 1978 only four banks were in operation, and in 1979 three new banks joined those included in this study. If the deposits of the 1979 entrants were excluded from 1979 total deposits, the total increase in 1979 deposits would still be significant, approximately 95 percent. In 1980 the overall increase in total deposits continued at the same pace, slightly over 100 percent. Data for 1981 and 1982 provide a meaningful trend in deposits growth. In 1981 and 1982 the total deposits of the eight banks increased 95 percent and 54 percent, respectively. The data in Table 8.1 indicate that the older banks show a steady and moderate growth and the new banks show a very high growth in deposits.

Based on information available on the Kuwait Finance House (KFH) and the Dubai Islamic Bank (DIB) for the years 1978, 1979, and 1980, this section provides a comparative analysis of the number and average balance of the deposit accounts for these banks. Table 8.2 shows that the KFH attracted a tremendous number of depositors in all deposit account categories, and the DIB attracted a considerably lower number of accounts. Furthermore, in 1979 the number of KFH current accounts increased by 140 percent, the number of savings accounts increased by 227 percent, and the number of time deposit

Table 8.1 Islamic banks: deposits, 1978–1982 (millions US$ and percentage growth)

	1978	*1979*	*1980*	*1981*	*1982*
Nasser Social Bank*	85.7	120.6	142.6	164.6	186.4
		41%	18%	15%	13%
Dubai Islamic Bank	34.8	38.8	54.2	91.5	112.9
		11%	40%	69%	23%
Islamic Development Bank†	10.1	2.9	16.6	61.2	67.1
		−71%	472%	269%	10%
Kuwait Finance House	77.5	244.0	547.8	1045.1	1614.3
		215%	125%	91%	54%
Faisal Islamic Bank, Egypt†		23.6	140.1	469.2	792.6
			494%	235%	69%
Faisal Islamic Bank, Sudan		43.6	99.0	113.6	224.6
			127%	15%	98%
Jordan Islamic Bank		16.0	40.5	77.3	102.0
			153%	91%	32%
Bahrain Islamic Bank†			13.1	27.1	54.0
				107%	99%
Total	208.1	489.5	1053.9	2049.6	3153.9
% growth		135	115	95	54

Sources: Compiled from bank annual reports.
* Data as of 30 June, the end of the fiscal year.
† Data as of end of Hijra calendar year.

Table 8.2 Number and average balance of deposit accounts for KFH and DIB, 1978–1980

	Kuwait Finance House			*Dubai Islamic Bank*		
	*Average balance (Kuwaiti dinars)**			*Average balance (UAE dirhams)**		
Type of account	*1978*	*1979*	*1980*	*1978*	*1979*	*1980*
Current accounts	880	2 113	3 601		1 622	1 955
% growth		140	70			21
Savings	4 365	14 287	32 288			
% growth		227	126			
					2 023	2 278
						13
Time	689	7 363	8 789			
% growth		969	19			
Current accounts	11 972	7 638	8 112		25 513	32 153
% change		−36	6			26
Savings	1 123	1 496	1 706			
% change		33	14			
					50 011	59 785
						20
Time	8 094	3 897	7 319			
% change		−52	88			

Sources: Compiled from bank annual reports.
* Kuwaiti dinar = US$3.686 and UAE dirham = US$0.2724 on the basis of the market rate/central rate stated in the International Financial Statistics, **XXXIV** (2), February 1981, International Monetary Fund, Washington, DC.

accounts increased by 969 percent. However, the 1980 increase slowed to 70 percent, 126 percent, and 19 percent, respectively, for the current, savings, and time deposit accounts. The average balance of each category of accounts fluctuated over the 3-year period. The average balance of KFH current and time deposit accounts dropped in 1979 and then increased in 1980, but the average balance in the savings accounts showed a slight and steady increase.

Table 8.2 also shows that the number of current accounts at the DIB increased by 21 percent during 1980, and the number of savings and time deposit accounts increased by 13 percent during the same period. This growth was accompanied by a 26 percent increase in the average balance of the current accounts and a 20 percent increase in the average balance of the savings and time deposit accounts. This moderate growth may be explained by the fact that DIB is one of the oldest Islamic banks, established in 1975. Consequently, the growth in the number of accounts is more stable, and the increase in the average balance may have occurred as a result of the confidence and acceptance granted by the deposit customers. This growth also may be explained by the possibility that deposit customers feel comfortable in dealing with Islamic

banks because they can relate to them in spiritual, social, and religious terms. The same conditions may apply to the KFH, but the 1979 drop in the KFH average balance of the current and time deposit accounts may be attributed to the considerable increase in the number of related accounts. This fact suggests that the majority of these accounts were for smaller deposit amounts.

The composition of the current and time deposit accounts of all the Islamic banks, as shown in Table 8.3, indicates a variance that may be explained by differences in the objectives, operational policies, and social services of the banks as well as the choices and needs of the depositors. It is reasonable to assume that the greater the ratio of the time deposit accounts to current accounts, the greater the confidence of the depositors in the ability of the bank to generate profits on the investment of deposited funds. On the other hand, the greater the ratio of current accounts to time deposit accounts, the greater the need of the depositors for ready and available cash for their personal, business, and social transactions. It may also imply that the bank provides better banking and social services.

Table 8.3 indicates that over the 5-year period 1978 to 1982, the depositors at the Nasser Social Bank, the Dubai Islamic Bank, the Faisal Islamic Bank of Egypt, the Kuwait Finance House, and the Bahrain Islamic Bank committed a high percentage of their deposits, approximately 70 to 95 percent, to savings and time deposit accounts. However, depositors at the Faisal Islamic Bank of Sudan committed 58 to 84 percent of their deposits to current accounts despite the fact that these accounts are not entitled to dividends. Depositors of Jordan Islamic Bank committed fewer deposits, approximately 50 to 60 percent, to savings and time deposit accounts. The Islamic Development Bank does not accept current accounts, but the percentage of these accounts shown in Table 8.3 represents funds received from the Jerusalem Fund, assumed to be current deposit. Furthermore, the IDB savings and time deposit percentage represents deposits received in 1981 and 1982 from the investment certificates scheme introduced in late 1980.

Equity Growth

The equity of Islamic banks consists of contributed or paid-up capital, capital reserves, and undistributed profits. The paid-up capital represents the authorized capital stated in the Articles of Agreement or as amended after the establishment of the bank, minus the unpaid capital. At the end of 1982, the capital of four Islamic banks, the Nasser Social Bank, the Dubai Islamic Bank, the Kuwait Finance House, and the Jordan Islamic Bank, was fully paid up, as shown in Table 8.4. The paid-up capital of other banks ranged between 25 percent and 74 percent of the authorized capital.

Table 8.4 shows that the total paid-up capital of the eight banks was US$1171.3 million at the end of 1982, representing 49 percent of the total authorized capital. Most of the Islamic banks included in this study increased their authorized capital within a short period of time in order to satisfy the demand for their shares and strengthen their ability to meet their objectives.

Table 8.3 Islamic banks: composition of deposit accounts, 1978–1982 (percentage)

	1978		1979		1980		1981		1982	
	Current account deposits	*Savings and time deposits*	*Current account deposits*	*Savings and time deposits*	*Current account deposits*	*Savings and time deposits*	*Current account deposits*	*Savings and time deposits*	*Current account deposits*	*Savings and time deposits*
Nasser Social Bank	6	94	5	95	5	95	5	95	6	94
Dubai Islamic Bank			29	71	32	68	30	70	28	72
Islamic Development Bank*	100		100		100		18	82	20	80
Kuwait Finance House	50	50	24	76	20	80	19	81	15	85
Faisal Islamic Bank, Egypt			31	70	6	94	7	93	5	95
Faisal Islamic Bank, Sudan			84	16	81	19	58	42	63	37
Jordan Islamic Bank			51	49	39	61	47	53	45	55
Bahrain Islamic Bank					40	60	23	77	15	85

Sources: Compiled from bank annual reports.
* Assumes that the Jerusalem Fund is a current deposit.

Table 8.4 Islamic banks: capital and reserves at the end of 1982 (millions US$)

	Year established	*Authorized capital*	*Paid-up capital*	*% paid-up*	*Capital reserve and undistributed profits*	*% of reserves and undistributed profits to paid-up capital*
Nasser Social Bank*	1972	28.57	28.57	100	28.13	99
Dubai Islamic Bank	1975	13.62	13.62	100	3.38	25
Islamic Development Bank†	1975	2146.46	1000.65	47	241.68	24
Kuwait Finance House	1977	51.18	51.05	100	70.53	138
Faisal Islamic Bank, Egypt†	1977	40.00	29.63	74	73.75	249
Faisal Islamic Bank, Sudan	1977	55.5	21.33	39	35.9	168
Jordan Islamic Bank	1978	11.11	11.11	100	0.73	7
Bahrain Islamic Bank†	1979	61.17	15.30	25	3.05	20
Total		2407.61	1171.26	49	457.15	39

Sources: Compiled from bank annual reports.
* Data as of 30 June 1981.
† Data as of end of the Hijra year 1402.

For example, the Nasser Social Bank, which was established in 1972 with an authorized capital of 6 million Egyptian pounds, increased its capital in 1978 to 10 million and in 1981 to 20 million. The Faisal Islamic Bank of Egypt, which was established in 1977 with an authorized capital of US$8 million, increased its authorized capital to US$30 million two and a half months after the initial subscription in order to meet the heavy demand for its capital shares. The authorized capital was increased to US$40 million five months after the first increase. According to the bank, this repeated favorable response reflects deep faith in the Islamic banking concept and great confidence in the Faisal Islamic Bank of Egypt. The Faisal Islamic Bank of Sudan had to increase its authorized capital during the first year of operation, from 6 million to 10 million Sudanese pounds, as a result of oversubscription. In 1981, two and a half years later, the FIB of Sudan increased its authorized capital to 50 million Sudanese pounds. The Bahrain Islamic Bank increased its authorized capital in 1980 from 20 million to 23 million Bahraini dinars in order to allow the Islamic Development Bank to purchase 6.52 percent of its subscribed capital. All of these developments reflect the acceptance of these banks by business and private communities, and their determination to cooperate with and assist each other.

The Islamic banks appropriate specific percentages of their profits to capital reserves. The appropriations, a source of internal financing, are either mandatory by law or voluntary. In the annual reports of the banks, the mandatory reserve is referred to as 'legal' reserve, while the voluntary reserve is referred to as 'general' or 'special' reserve. The two reserves amount to a substantial sum of money and are considered an integral part of the bank capital. The amounts of accumulated mandatory and voluntary reserves depend on the profitability of the bank, the number of years during which the bank appropriated the reserves, and the percentage appropriated.

The third category of capital composition is the undistributed profits, which includes the profits proposed for distribution and the retained earnings. The amount of profit proposed for distribution is normally shown in the capital section of the balance sheet until the board of directors declares it. At this point it becomes a liability until paid to the shareholders. The amount of retained earnings, which is carried forward to the succeeding years, is less significant as a source of financing than the paid-up capital and the mandatory and voluntary reserves. This is due to the fact that the Islamic banks distribute all or most of their profits to shareholders after the payment of dividends to depositors and after the appropriation of the reserves. The total amount of the reserves and the undistributed profits at the end of 1982 was approximately US$457.2 million (see Table 8.4), an amount that represents 39 percent of the paid-up capital. Over the years this amount becomes a significant source of internal financing and adds financial strength to the banks and offers financial security to the stockholders and depositors. In summary, the total capital of the Islamic banks amounted to US$1628.4 million at the end of 1982, 72 percent of which was derived from paid-up capital, and 28 percent from reserves and undistributed profits.

Asset Growth

Total asset growth, especially investment and loans, is the best overall indication of growth for Islamic banks. Table 8.5 shows the growth in total assets for the years 1978–1982. Total assets exclude contra assets which comprise customer liabilities held against letters of credit, guarantees and acceptances, safe keeping deposits, Zakat funds, and securities held for others. The contra assets appear below the line in the financial statements because they do not represent funds available for the bank's own use.

Table 8.5 shows that the two banks owned exclusively by governments, the Islamic Development Bank and the Nasser Social Bank, ranked first and second, respectively, in terms of size in 1978 and 1979. The Kuwait Finance House leaped to second place in 1980 and 1981, leaving the Nasser Social Bank behind in the third place in 1980 and in the fourth place during 1981. The Kuwait Finance House experienced a substantial growth in assets from its establishment onwards, and in 1982 it became the number one bank in terms of total assets. The Faisal Islamic Bank of Egypt is another bank which has shown a tremendous growth in total assets since it began operations in 1979.

By any measure, the asset growth rates of each of the eight Islamic banks

Table 8.5 Islamic banks: asset growth, 1978–1982 (millions US$ and percentages)

	1978	*1979*	*1980*	*1981*	*1982*
Nasser Social Bank*	234.21	318.28	330.04	396.83	443.13
		36%	4%	20%	12%
Dubai IslamicBank	53.23	65.34	75.82	112.75	138.53
		23%	16%	49%	23%
Islamic Development Bank†	816.44	1105.07	1241.49	1270.83	1475.00
		35%	12%	2%	16%
Kuwait Finance House	95.34	277.41	620.90	1247.76	1940.58
		191%	124%	101%	56%
Faisal Islamic Bank, Egypt†		38.74	197.16	588.88	996.51
			409%	199%	69%
Faisal Islamic Bank, Sudan		62.27	134.70	153.58	308.48
			116%	14%	101%
Jordan Islamic Bank		23.54	50.13	93.23	125.94
			113%	86%	35%
Bahrain Islamic Bank†			30.15	46.31	76.24
				54%	65%
Total	1199.22	1890.65	2680.39	3910.17	5504.41
% growth		58	42	46	41

Sources: Compiled from bank annual reports.
* Data as of 30 June, the end of the fiscal year.
† Data as of end of Hijra calendar year.

listed in the table, with the exception of the Nasser Social Bank in 1980, are unusual. These banks surpassed the asset growth rates of the top 500 banks in the world, the average growth rate of which reached 17 percent in 1979 and 10 percent in 1980.[1] In fact, the 1979 growth rates of the Islamic banks exceeded the average growth rate of the top 10 banks in the USA, the European Economic Community countries, Japan, and the world as a whole.[2] The same is true of 1980 and 1981, with the exception of the two Islamic banks owned by governments. The Islamic Development Bank and the Nasser Social Bank realized growth rates below the average of the top 10 banks in the world. It is important, however, to point out that while the Islamic banks are not included on the list of the top 500 banks in the world because of their relatively small size, their rate of growth indicates considerable future potential.

Structural Analysis of Deposits, Equity, and Assets

The structural analysis of deposits, equity, and assets involves the consideration of two main ratios, the deposits to equity ratio and the equity to assets ratio. The deposits to equity ratio is known in the finance literature as debt (deposits) to equity ratio, and the equity to assets ratio is known as the capital ratio. An analysis of the composition of debt and equity in Islamic banking is important due to the restrictions imposed on the use of certain sources, such as current accounts deposits, for investment or loan purposes. Another restriction involves the separate accounting required for profits generated from funds contributed by depositors and shareholders. It should be repeated that Islamic banks are not committed to the payment of a fixed rate of interest on time deposits. Instead, they invest time deposits on behalf of the depositors and charge what is known as a 'management fee'. The remaining profit from investment is distributed among the depositors. For this reason, the principle of trading on the equity or financial leverage does not apply in Islamic banking. Trading on the equity involves the use of debt in the capital structure to increase the return on investment to the owners. Trading on the equity tends to magnify the earnings of commercial banks during favorable economic conditions and increase losses during depressed economic conditions. During depressed economic conditions repayment of deposits and deposit interest becomes a burden on the commercial banks and may lead to financial difficulties, even for successful and profitable banks.

The trading-on-the-equity concept does not apply in Islamic banking because time deposits are employed in investment projects that could be as profitable as the investment financed by funds derived from shareholders' equity. The increase in time deposits adds strength to the financial condition of the bank and creates a significant advantage for the shareholders. The reason for this, as noted earlier, is that the bank charges a fee for its role in developing the investment projects financed by the time depositors, and the fee is added to the profits distributed to shareholders. In addition, the deposits and equity capital funds may be added together and invested in large and profitable

projects that benefit both depositors and shareholders. It is difficult to determine what ratio of debt to equity is appropriate, safe, and acceptable by financial management standards. The proper ratio of debt to equity may vary from bank to bank, depending on the nature of operations, the purpose of the establishment of the bank, and other economic and business considerations. The important criterion for this relationship is that debt should be kept within the limits of management's ability to invest the funds from all sources in safe and profitable projects.

An examination of total amounts of debt and equity for the eight Islamic banks included in this study reveals several factors related to the debt to equity ratio. Table 8.6 shows that the Islamic banks primarily depend on capital sources of funds in the early stages of their operations. Once the bank gains the confidence of the community through equity capital, it is able to attract funds from current, savings, and time depositors.

Table 8.6 also reveals that the debt to equity ratio for the older banks, the Nasser Social Bank and the Dubai Islamic Bank, slightly increased over the 5-year period 1978–1982, ranging between 1.32 and 6.64. The Islamic Development Bank did not accept any current or time deposit accounts, and until the end of 1980 relied mainly on capital sources of funds. During 1981 and 1982 the Islamic Development Bank accepted investment deposits in order to increase its foreign trade financing capability. These deposits increased from 43.8 million Islamic dinars (US$47.0 million) at the end of 1401 AH (1981) to 50.04 million Islamic dinars (US$53.7 million) at the end of 1402 AH (1982), about 14.3 percent.

The Kuwait Finance House debt to equity ratio is the highest among the ratios of all the Islamic banks. The ratio jumped from 7.45 in 1978, the first year of operation, to 20.33 in 1979 and to 28.24 in 1980. However, the ratio declined in 1981 to 16.25 and in 1982 to 13.28. The heavy dependence of the KFH on deposits as a source of funds, and the steady increase in these deposits over the first 3 years of operation, reflect the growing faith of depositors in the bank's management and its ability to generate profits. The KFH total equity increased 231 percent in 1981 and 89 percent in 1982 as a result of collecting the remaining percentage of capital subscriptions and increasing its paid-up capital, causing the debt to equity ratio increase to decrease during these 2 years despite the 91 percent increase in 1981 and 55 percent increase in 1982 in total deposits.

The experience of the other four banks included in this study, the Faisal Islamic Bank of Egypt, the Faisal Islamic Bank of Sudan, the Jordan Islamic Bank and the Bahrain Islamic Bank, is limited. However, debt to equity ratios of these banks are either close to or substantially more than those of the older and well-established banks, the Nasser Social Bank and the Dubai Islamic Bank. This fact reveals depositor and community acceptance of the newer banks. It also reflects the confidence placed in the ability of the bank management to generate profits on investment. The degree of this ability is examined in the following sections dealing with the utilization of funds and the profitability assessment.

Table 8.6 Islamic banks: debt to equity ratio, 1978–1982 (millions US$)

	1978	*1979*	*1980*	*1981*	*1982*
Nasser Social Bank*					
Debt	85.7	120.6	142.6	164.6	186.4
Equity	64.9	85.1	90.23	97.1	103.8
Debt–equity ratio	1.32	1.42	1.58	1.70	1.8
Dubai Islamic Bank					
Debt	29.5	38.8	54.2	91.5	112.9
Equity	14.2	15.3	16.3	16.6	17.0
Debt–equity ratio	2.08	2.54	3.33	5.51	6.64
Islamic Development Bank†					
Debt	10.1	3.0	16.6	61.2	67.1
Equity	747.5	978.8	1119.8	1079.2	1242.3
Debt–equity ratio	0.01	NIL	0.01	0.06	0.05
Kuwait Finance House					
Debt	77.5	244.0	547.8	1045.1	1614.3
Equity	10.4	12.0	19.4	64.3	121.6
Debt–equity ratio	7.45	20.33	28.24	16.25	13.28
Faisal Islamic Bank, Egypt†					
Debt		23.6	140.1	469.2	792.6
Equity		13.2	29.5	54.1	103.4
Debt–equity ratio		1.79	4.75	8.67	7.7
Faisal Islamic Bank, Sudan					
Debt		60.1	99.0	113.6	224.6
Equity		10.2	15.6	25.9	57.2
Debt–equity ratio		5.89	6.35	4.39	3.93
Jordan Islamic Bank					
Debt		12.8	37.7	77.3	102.0
Equity		6.1	6.5	9	11.8
Debt–equity ratio		2.10	5.80	8.59	8.61
Bahrain Islamic Bank†					
Debt			12.7	27.1	54.0
Equity			16.4	16.5	18.4
Debt–equity ratio			0.78	1.64	2.93

Sources: Compiled from bank annual reports.
* Data as of 30 June, the end of the fiscal year.
† Data as of end of hijra year.

The capital to assets ratio, known as capital ratio, indicates the ability of the bank to generate or attract capital and to achieve its objectives over a period of time. In Islamic banking the impact of this ratio reflects changes in a bank's capital position. A change in the capital ratio indicates that there is expansion or contraction in the invested capital or deposit accounts. Since savings and time depositors are not guaranteed a fixed rate of return, a higher or lower capital ratio changes the degree of risk assumed by depositors. In the event of temporary losses in the joint investment operations of the bank, or in the case

of liquidation, a relatively high capital ratio provides a cushion or safety valve for the depositors.

Table 8.7 shows that Islamic banks, with the exception of the Kuwait Finance House, have a very high capital ratio compared with the top 50 banks of the world, the ratios of which ranged between 0.4 and 6.96 in 1979, between 0.42 and 7.02 in 1980, and between 6.85 and 18.61 in 1981.[3] It is normal to expect a high capital ratio in the early years of operation; the ratio then declines or stabilizes as the bank gains the confidence of depositors. This has been true in

Table 8.7 Islamic banks: capital ratio, 1978–1982 (millions US$)

	1978	*1979*	*1980*	*1981*	*1982*
Nasser Social Bank*					
Capital and reserves	64.9	85.1	90.3	97.1	103.8
Total assets	234.2	318.3	330.0	396.8	443.1
Capital ratio	28	27	27	24	23
Dubai Islamic Bank					
Capital and reserves	14.2	15.3	16.3	16.6	17.0
Total assets	53.2	65.3	75.8	112.8	138.5
Capital ratio	27	23	22	15	12
Islamic Development Bank†					
Capital and reserves	747.5	978.8	1119.8	1079.2	1242.3
Total assets	816.4	1105.1	1241.5	1270.8	1475.0
Capital ratio	92	89	90	85	84
Kuwait Finance House					
Capital and reserves	10.4	12.0	19.4	64.3	121.6
Total assets	95.3	277.4	620.9	1247.8	1940.6
Capital ratio	11	4	3	5	6
Faisal Islamic Bank, Egypt†					
Capital and reserves		13.2	29.5	54.1	103.4
Total assets		38.7	197.2	588.9	996.5
Capital ratio		34	15	9	10
Faisal Islamic Bank, Sudan					
Capital and reserves		10.2	15.6	25.9	57.2
Total assets		62.3	134.7	153.6	308.5
Capital ratio		16	12	17	19
Jordan Islamic Bank					
Capital and reserves		6.1	6.5	9.0	11.9
Total assets		23.5	50.13	93.2	125.9
Capital ratio		26	13	10	9
Bahrain Islamic Bank†					
Capital and reserves			16.4	16.5	18.4
Total assets			30.2	46.3	76.2
Capital ratio			54	36	24

Sources: Compiled from bank annual reports.
* Data as of 30 June, the end of the fiscal year.
† Data as of end of Hijra calendar year.

the case of the Kuwait Finance House, the Faisal Islamic Bank of Egypt, the Faisal Islamic Bank of Sudan, the Jordan Islamic Bank, and the Bahrain Islamic Bank. The KFH capital ratio, which is in line with the average capital ratio of the top 50 banks of the world, is the lowest ratio among the eight Islamic banks included in Table 8.7, indicating a higher degree of reliance on financing the assets through an increase in deposits rather than an increase in equity capital.

The high capital ratio is an important feature of Islamic banking because it indicates to equity borrowers, depositors, and shareholders a continuity in investments, financing, and lending policies. Since savings and time investment accounts in Islamic banks are on an equal footing with shareholders in terms of the employment of funds in specified investment projects and profit distribution, depositors would normally have a long-term investment objective when they contribute to such accounts. This may be true particularly in the case of large unlimited period investment accounts and limited period accounts which are placed with an intent to renew the commitment. Furthermore, individual depositors have no protection or guarantee, such as that provided by the Federal Deposit Insurance Corporation in the USA, against possible major losses. For this reason, depositors of large balance amounts and financial analysts would be on the watch for any major changes in capital ratios which might indicate a shift or major change in capitalization policy.

The concept of capital ratio in Islamic banking is not as relevant to customers as in commercial banking because, generally speaking, Islamic banks do not extend loans to customers. The Islamic Development Bank and the Nasser Social Bank, both extend loans on the basis of cost recovery rather than a fixed rate of interest since both are government owned and show a high capital ratio. The continuity of a high capital ratio assures loan customers of the continuance of the operating policy of these banks, particularly customers who plan to apply for substantial loans for development projects such as those offered by the IDB.

The implication of a high capital ratio for the existing shareholders is linked to the flow of profit distribution and to the appreciation of the market value of the capital shares. The existing shareholders may not be interested in new share offerings being made available, to prevent dilution of the earnings per share and the possible reduction in market value per share. This explains why the private Islamic banks have been slow in requesting the full payment of the subscribed shares from their existing shareholders.

In conclusion, Islamic banks possess high capital ratios because of the lack of a fixed interest rate in profit distribution and the confidence placed in the management and the profitability of their operations. Such conditions have effected a relatively high rate of deposits from all types of depositors who previously relied on a high capital ratio as one of the indicators in increasing their deposits. The capital ratio thus provides an important measure of confidence in the management of Islamic banks as they seek to avoid unhealthy investment risks.

UTILIZATION OF FUNDS

The utilization of funds available to Islamic banks from all sources in financing investment projects is of prime importance, not just for the generation of more funds, but for the success of the Islamic banking experience. The analysis of funds utilization centers around the efficient management of the available investment funds and their contribution to economic development. This section covers (1) loans and investments, (2) funds utilization ratio, and (3) assessment of funds utilization.

Loans and Investments

With the exception of the two banks owned by governments, Islamic banks normally do not extend loans because of the Islamic prohibition on receiving a fixed rate of return on money loaned to customers. When Islamic banks extend loans to customers they charge a fee to recover the administrative costs of the loan. This fee is not based on the amount or the length of time of the loan. The two government banks that extend loans to customers are the Nasser Social Bank and the Islamic Development Bank. The Nasser Social Bank extends loans for social, productive, educational, pilgrimage, and alimony debt purposes. The Egyptian government, however, contributes to these loans through a special allocation of funds to the NSB. This allocation amounted to 91 percent and 77 percent of the total social loans granted by the NSB in 1980 and 1981, respectively. The IDB, on the other hand, extends loans for economic development purposes. Normally, these loans are confined to infrastructure projects having a marked impact on the long-term process of socioeconomic development. Furthermore, loans are granted for technical assistance purposes, such as feasibility studies, preliminary designs, or consulting services. The total amount of the IDB loans ranged between 8 and 12 percent of the total amount of outstanding loans and investments in each of the 5 years of this study (1978–1982).

The other Islamic banks sometimes make exceptions and extend loans, free of interest charges, to specific customers. For example, the Dubai Islamic Bank extends loans in the form of advances to parties connected with or related to the projects owned by the bank. The DIB justifies this practice by the fact that it helps in business development, and by the increase in the number of customers. The total amount of the DIB loans ranged between 3 and 14 percent of the total amount of outstanding loans and investment in each of the 5 years covered in this study. To give another example, the Kuwait Finance House makes advances to customers against letters of credit. These advances are included in the total outstanding loans and investments shown in Table 8.8 because they are advances on the Murabahah investments and not because they are loans similar to those offered by NSB or IDB.

Table 8.8 shows the total loans and investments made by the eight Islamic banks over the years 1978–1982. The table indicates that the total loans and

Table 8.8 Islamic banks: loans and investments, 1978–1982 (millions US$ and percentage growth)

	1978	*1979*	*1980*	*1981*	*1982*
Nasser Social Bank*	96.2	130.6	133.6	156.9	147.7
		36%	2%	17%	−6%
Dubai Islamic Bank	36.4	45.3	55.7	79.2	106.4
		24%	23%	42%	34%
Islamic Development Bank†	117.0	333.3	514.6	759.8	751.6
		185%	54%	48%	−1%
Kuwait Finance House	29.3	135.3	247.1	501.5	1009.8
		362%	83%	103%	101%
Faisal Islamic Bank, Egypt†		24.1	154.9	354.4	833.4
			543%	129%	135%
Faisal Islamic Bank, Sudan		32.9	78.5	79.0	251.9
			139%	1%	219%
Jordan Islamic Bank		2.6	24.7	44.9	77.9
			850%	82%	73%
Bahrain Islamic Bank†			21.6	34.2	65.2
				58%	91%
Total	278.9	704.1	1230.7	2009.9	3243.9
% growth		152	75	63	61

Sources: Compiled from bank annual reports.
* Data as of 30 June, the end of the fiscal year.
† Data as of end of Hijra calendar year.

investments increased substantially over the 5 years. However, the last 3 years, 1980–1982, provide more reliable growth rates of the amounts because three of the banks started operations in 1979 and one in 1980. The growth rates of loans and investments for the older banks, NSB, DIB, and IDB, are more reliable because the year 1978 was a full year of operations for them, while the base year for the other five banks was not a full year of operations. The two banks owned by governments show a decreasing rate of increase in total loans and investments after 1979 while the privately owned banks show an impressive increase. It is interesting to note that the KFH in 1982 took the lead in the total loans investments, reflecting active investment operations and efficient employment of funds derived from deposits and equity capital.

Funds Utilization Ratio

The funds utilization ratio is derived by dividing the total amount of loans and investments by the total amount of available funds for loans and investments. The latter includes all deposits, except current accounts, and total capital and reserves. The current accounts are excluded because they can be withdrawn on

demand and are not entitled to any profit distribution. The higher ratio suggests complete or near complete employment of funds generated from time deposits accounts and capital in investment activities. The difference between the utilization ratio indicated in the table and 100 percent represents the amount of idle cash on hand or in foreign banks, and other uses of funds. If the utilization ratio exceeds 100 percent it implies that the bank employed the amounts received from its current accounts depositors in its investment activities. Actually, this was the case of the Dubai Islamic Bank, the Faisal Islamic Bank of Sudan, the Jordan Islamic Bank, and the Bahrain Islamic Bank.

Assessment of Funds Utilization

The assessment of funds utilization by Islamic banks centers around their contribution to the economic and social development of the Islamic countries. The data in Table 8.9 suggest a genuine increase in funds utilization which is steady and significant for all banks. The efforts of funds utilization in financing development projects is one aspect of the role of Islamic banks in economic development. Another aspect is the mobilization of hoarded funds into the financial markets. Religious prohibitions kept money savers and entrepreneurs isolated from the development process. Savers or owners of resources, and entrepreneurs who lacked funds for investment, were joined through Islamic banks, resulting in an increase in the productive capacity of Muslim and developing countries and providing new employment opportunities for the people of these countries. Since Islamic banks enter into joint or partnership investment activities with individual entrepreneurs or business firms, they have to concentrate on the feasibility and profitability of the projects they finance. For this reason, Islamic banks provide the necessary link between financing and the determination of the economic feasibility of investment projects. Furthermore, since these projects contribute to the gross national product of the country, they provide goods and services which narrow the gap between supply and demand and, as a result, contribute to the reduction of inflationary pressures. This role will not be positive unless Islamic banks concentrate on financing the projects of the commodity production sectors and increase the supply of goods and services.* As can be seen from Table 8.10, the financing priorities of the Islamic banks were directed primarily towards the trade and real estate sectors and to a lesser extent towards the industrial sector.

Three banks located in the Gulf area, the Dubai Islamic Bank, the Kuwait Finance House, and the Bahrain Islamic Bank, concentrated their investment efforts in real estate projects financing, primarily in land and building or housing projects. The other Islamic banks concentrated their investment efforts in financing trade, commodities, and motor vehicles – particularly foreign trade. Some of these banks gave their next priority to industry and mining, utilities, tourism, and agriculture.

The role of Islamic banks in economic development during 1978–1980 was confined mainly to trade financing because most of the banks were newly

Table 8.9 Islamic banks: funds utilization ratio, 1978–1982 (millions US$)

	1978	*1979*	*1980*	*1981*	*1982*
Nasser Social Bank*					
Deposits plus capital & reserves	145.3	200.2	225.9	253.7	280.0
Loans and investments	96.2	130.6	133.6	156.9	147.7
Utilization ratio	66	65	59	62	53
Dubai Islamic Bank					
Deposits plus capital & reserves	38.7	43.1	53.4	81.0	98.2
Loans and investments	36.4	45.3	55.7	79.2	106.4
Utilization ratio	79	105	104	98	108
Islamic Development Bank†					
Deposits plus capital & reserves	747.5	978.7	1119.8	1129.2	1296.0
Loans and investments	117	333.3	514.6	759.8	751.6
Utilization ratio	16	34	46	67	58
Kuwait Finance House					
Deposits plus capital & reserves	49.1	196.9	459.5	913.3	1496.9
Loans and investments	29.3	135.3	247.1	501.5	1009.8
Utilization ratio	60	69	54	55	67
Faisal Islamic Bank, Egypt†					
Deposits plus capital & reserves		29.6	162	490.5	858.4
Loans and investments		24.1	154.9	354.4	833.4
Utilization ratio		81	96	72	97
Faisal Islamic Bank, Sudan					
Deposits plus capital & reserves		17.2	34.31	73.4	139.5
Loans and Investments		32.9	78.5	79.0	251.9
Utilization ratio		191	229	108	180
Jordan Islamic Bank					
Deposits plus capital & reserves		13.9	31.3	50.3	68.4
Loans and investments		2.5	24.7	44.9	77.9
Utilization ratio		18	79	89	114
Bahrain Islamic Bank†					
Deposits plus capital & reserves			24.3	37.4	64.4
Loans and investments			21.6	34.2	65.2
Utilization ratio			89	91	101

Sources: Compiled from bank annual reports.
* Data as of 30 June, the end of the fiscal year.
† Data as of end of Hijra calendar year.

Table 8.10 Islamic banks: investment priorities, 1978–1982

	Investment sectors (by descending order of priority)
Nasser Social Bank	Trade and tourism
Dubai Islamic Bank	Real estate, trade, industry, fisheries, Islamic insurance, and consumer cooperative
Islamic Development Bank	Foreign trade, industry and mining, transportation and communication, utilities, agriculture, social services, and other sectors
Kuwait Finance House	Real estate, commodity trade, shares of Islamic banks, and business and investment
Faisal Islamic Bank, Egypt	Trade, housing, health services, industry, agriculture, and transportation
Faisal Islamic Bank, Sudan	Trade, industry, and insurance
Jordan Islamic Bank	Trade, industry and mining, agriculture, transportation, tourism, and professions
Bahrain Islamic Bank	Trade, real estate, securities and shares of Islamic banks and investment companies

Sources: Compiled from bank annual reports.

established, and their experience in financing industrial or agricultural projects was limited. For this reason they followed the easier route of investing in real estate and foreign trade. This situation has already changed with the growing stability in the construction and real estate market and export/import activities. During the early 1980s most of the Islamic banks diversified their investments in sectors appropriate to the specific changing economic conditions in the Muslim countries where they operate and the general international economic conditions. A noticeable trend in the 1980s includes direct investment by these banks in capital shares of Islamic investment and insurance companies, other Islamic banks, and consumers' cooperatives. However, the investment trend in industrial and agricultural projects is still limited despite the few additional projects financed by Islamic banks in these important sectors.

PROFITABILITY ANALYSIS

Philosophical differences between Islamic banks, commercial banks, and other financial or investment institutions lead to different profitability measures. Islamic banks' profitability measures are limited to those related to operations permitted by the Islamic Shariah. Measures that involve interest or practices prohibited by Islam are excluded. The growth of net profit to assets, the growth of net profit to total deposits and capital and reserves, and profit distribution,

constitute the primary analytical tools used to assess bank performance. Implications of profitability for depositors, shareholders, and borrowers or investment partners are discussed in the light of the Islamic bank philosophy. Success in the use of funds supplied to the banks is expressed simply in the ratio of net profit to funds utilized in the lending and investment operations. In this section profitability analysis covers (1) net profit calculation, (2) return on assets, (3) net profit to revenue ratio, (4) rate of return on time deposits and equity, (5) profit distribution to time depositors, and (6) profit distribution to shareholders.

Net Profit Calculation

Net profit in Islamic banking constitutes income or revenue minus expenses and taxes. Income or revenue is derived from the following sources:

(1) Banking service charges
(2) Income from banking operations.
(3) Profit on sale of investment.
(4) Income from direct investments.
(5) Income from investments in profit-sharing ventures.
(6) Income from operations in foreign currency.
(7) Income from subsidiaries.
(8) Dividend from shareownership in other banks and companies.

Expenses of Islamic banks include:

(1) Salaries of employees and managers.
(2) Staff bonuses.
(3) Depreciation of fixed assets.
(4) Amortization of deferred expenses.
(5) Provisions for doubtful debts.
(6) Provisions for decline in value of investment.
(7) Taxes and Zakat.
(8) Rent.
(9) Supplies and other miscellaneous expenses.

Examination of the profit and loss statements of Islamic banks reveals that there is no general agreement on the methods utilized in the calculation of depreciation, provision for doubtful debts, or the inclusion of provision for decline in value of investment. Furthermore, some banks include employee bonuses in total expenses while others allocate them after the calculation of net profit. The methods of calculation and reporting of the Zakat tax are not uniform due to basic differences in the application of the Zakat philosophy. Some banks ignore the Zakat tax on the assumption that depositors and shareholders will include their share of distributed profit in their taxable base for the calculation of Zakat. Other banks calculate the Zakat tax on the basis of net worth, net profit plus capital and reserves. These banks consider Zakat as

an expense that reduces net profit, or they have treated the Zakat as an appropriation of profits to a Zakat account in the same manner as appropriation of profits to general or statutory reserves. The amount of Zakat in all cases is not material compared with the total realized net profit.

The assessment of profitability on the basis of net profit reported by Islamic banks is complicated because of the lack of uniformity in the application of accounting policies, discussed earlier in this chapter. Moreover, the utilization of exchange rates in the conversion of the operating results, which make the assessment quite difficult, leads to the conclusion that judgment of performance on the basis of profit alone is not justified. However, profit provides the prime indicator of a bank's performance, and contribution to economic and social development becomes a secondary indicator of the bank's success.

Return on Assets

The effectiveness of bank management in performing various financing activities is measured by profitability ratios which indicate the productive use of the resources available to management and the degree of risk taken in the profit-sharing ventures or in any other practice or method permitted by the Islamic Shariah. An indicator of the relative effectiveness of the utilization of the assets is the ratio of profit from operations to total assets or, briefly, the return on assets ratio, shown in Table 8.11.

The return on assets ratio provides a rough and broad measure of the ability of management to generate earnings from the bank's activities regardless of the source of the funds that support these activities. Table 8.11 indicates that the return on assets ratio of six of the eight Islamic banks included in this study ranged between 2.10 and 8.07 percent. The other two banks, the Islamic Development Bank and the Jordan Islamic Bank, show a very low return on assets ratio, an indication of management difficulties. However, this ratio improved slightly for both banks in 1981 and 1982, but it is still behind the ratios of the other six banks. Aside from the possibility of the presence of data which cannot be compared between banks, the variations may be attributed to several reasons. These reasons include the changing make-up and timing of investment funds, overinvestment in assets in relation to overall earned revenues, efficiency in utilization of funds, general operations, or variations in economic and business conditions.

Net Profit to Revenue Ratio

Another measure of profitability that indicates management effectiveness is the ratio of net profit to total revenues. This ratio reflects the changes in total revenues and total operating expenses, both of which affect the net profit. Since data for each source of revenue and its related expenses are not available, the trend of net profit to revenue ratio provides a rough and overall indicator of

Table 8.11 Islamic banks: return on assets, 1978–1982 (millions US$)

	1978	*1979*	*1980*	*1981*	*1982*
Nasser Social Bank*					
Net profits	17.2	18.3	21.6	24.7	25.1
Total assets	234.2	318.3	330.0	396.8	443.1
Return on assets	7.34	5.75	6.55	6.23	5.67
Dubai Islamic Bank					
Net profits	3.2	1.6	3.0	4.4	6.7
Total assets	53.2	65.3	75.8	112.8	138.5
Return on assets	6.02	2.45	3.96	3.90	4.84
Islamic Development Bank†					
Net profits	−2.8	2.9	12.9	16.8	18.2
Total assets	816.4	1105.1	1241.5	1270.8	1475.0
Return on assets	−0.34	0.26	1.04	1.32	1.23
Kuwait Finance House					
Net profits	2.0	12.8	35.7	89.0	156.6
Total assets	95.3	277.4	620.9	1247.8	1940.6
Return on assets	2.10	4.61	5.75	7.13	8.07
Faisal Islamic Bank, Egypt†					
Net profits		1.4	9.8	32.4	69.4
Total assets		38.7	197.2	588.9	996.5
Return on assets		3.62	4.97	5.50	6.96
Faisal Islamic Bank, Sudan					
Net profits		2.1	5.2	11.4	23.5
Total assets		62.3	134.7	153.6	308.5
Return on assets		3.37	3.85	7.43	7.63
Jordan Islamic Bank					
Net profits			0.1‡	1.0	2.4
Total assets			50.1	93.2	125.9
Return on assets			0.10	1.07	1.91
Bahrain Islamic Bank†					
Net profits			1.5	1.8	4.8
Total assets			30.2	46.3	76.2
Return on assets			4.97	3.89	6.30

Sources: Compiled from bank annual reports.
* Data as of 30 June, the end of the fiscal year.
† Data as of end of Hijra calendar year.
‡ Includes profits for the last quarter of 1979.

management effectiveness in generating revenue with the least cost and expenses. Table 8.12 shows the Islamic banks' ratio of net profit to revenue for the years 1978–1982.

It is significant that the ratio of return on assets and the ratio of net profit to revenue complement each other. The trend of these two ratios moved in the same direction for most of the eight banks, an observation that shows the effect of the size of the assets on the revenues and expenses. Furthermore, the data in Tables 8.11 and 8.12 suggest that the increase in total assets in 1 year may not

Table 8.12 Islamic banks: net profit to revenue ratio, 1978–1982 (millions US$)

	1978	*1979*	*1980*	*1981*	*1982*
Nasser Social Bank*	16	16	18	16	24
Dubai Islamic Bank	75	67	76	65	61
Islamic Development Bank†	−74	23	52	56	56
Kuwait Finance House	58	74	70	74	88
Faisal Islamic Bank, Egypt†		73	81	90	93
Faisal Islamic Bank, Sudan		45	52	73	74
Jordan Islamic Bank			3‡	36	49
Bahrain Islamic Bank†			52	41	46

Sources: Compiled from bank annual reports.
* Data as of 30 June, the end of the fiscal year.
† Data as of end of Hijra year.
‡ Based on data which include revenues and net profits derived from operations of the last quarter of 1979.

effect an increase in revenue and profits in the same year. The length of time it takes the assets to generate revenues and profits depends on when the increase in assets took place during the year and on management effectiveness in allocating the available funds to speculative short-term or growth types of investment assets.

Rate of Return on Time Deposits and Equity

Another overall profitability measure is the rate of return on time deposits plus equity. This rate of return provides an indication for depositors and shareholders that may encourage them to add funds to their balances and purchase offerings of new shares. Profitability in this sense is important for the development of long-term strategies for the expansion of the bank's services. The rate of return on time deposits and equity for each of the eight banks included in this study is shown in Table 8.13.

It is important to point out that the data compiled in Table 8.13 are as reported in the financial statements without adjustments to make them comparable between the banks. However, the comparison between years for each bank is reliable because of the consistency in the reporting of revenue and expense figures as well as the time deposits and capital and reserves balances included in the statements. Since the rate of return shown in Table 8.13 is an average return for both savings and investment funds as well as equity funds, it may not be significant to each depositor or shareholder except that it shows the trend of profitability to both equity and debt contributors. Thus the profit distribution to time depositors, savings and investment accounts, and dividend distribution to shareholders, provide a better or more reliable indication of return on investment.

Table 8.13 Islamic banks: rate of return on deposits and equity, 1978–1982 (millions US$)

	1978	*1979*	*1980*	*1981*	*1982*
Nasser Social Bank*					
Net profits	17.2	18.3	21.6	24.7	25.1
Deposits & equity	145.3	200.2	225.9	253.7	280.0
Rate of return	12	9	10	10	9
Dubai Islamic Bank					
Net profits	3.2	1.6	3.0	4.4	6.7
Deposit & equity	38.7	43.1	53.4	81.0	98.2
Rate of return	8	4	6	5	7
Islamic Development Bank†					
Net profits	−2.8	2.9	12.9	16.8	18.2
Deposits & equity	747.5	978.7	1119.8	1129.2	1296.0
Rate of return	−0.37	0.30	1	1	1
Kuwait Finance House					
Net profits	2.0	12.8	35.7	89.0	156.6
Deposits & equity	49.1	196.9	459.5	913.3	1496.9
Rate of return	4	7	8	10	10
Faisal Islamic Bank, Egypt†					
Net profits		1.4	9.8	32.4	69.4
Deposits & equity		29.6	162.0	490.5	858.4
Rate of return		5	6	7	8
Faisal Islamic Bank, Sudan					
Net profits		2.1	5.2	11.4	23.5
Deposits & equity		17.2	34.3	73.4	139.5
Rate of return		12	15	16	17
Jordan Islamic Bank					
Net profits			0.045	1.0	2.4
Deposits & equity			31.3	50.3	68.4
Rate of return			0.14	2	4
Bahrain Islamic Bank†					
Net profits			1.5	1.8	4.8
Deposits & equity			24.3	37.4	64.4
Rate of return			6	5	7

Sources: Compiled from bank annual reports.
* Data as of 30 June, the end of the fiscal year.
† Data as of end of Hijra year.

Profit Distribution to Time Depositors

The data available on profit distribution to time depositors in Table 8.14 suggest that there is a substantial difference in the return on time deposit between banks. The highest return was that distributed by the Faisal Islamic Bank of Sudan and the lowest return was that distributed by the Jordan Islamic Bank. Furthermore, most of the banks included in the table show an absolute increase in the amount of time deposits, but a declining percentage increase.

Table 8.14 Islamic banks: profit distribution percentage of savings and investment account deposits, 1979–1982

	1979	*1980*	*1981*	*1982*
Nasser Social Bank*	9.5	7.7	10.8	10.1
Dubai Islamic Bank	4–6	4–6	5–7	6–9
Islamic Development Bank†	–	–	4.6	8.9
Kuwait Finance House	6.1–9.1	6.8–10.1	9–13.5	8–12
Faisal Islamic Bank, Egypt†	10.7	12.0	12.5	10.2–11.6
Faisal Islamic Bank, Sudan	14.7	16	14.8–15.9	14.5–15.5
Jordan Islamic Bank		4.1–7.4	3.4–6.1	3.6–6.5
Bahrain Islamic Bank†		5.3–9.5	NA	NA

Sources: Compiled from bank annual reports.
* Data as of 30 June, the end of the fiscal year.
† Data as of end of Hijra year.

The decline in the percentage increase may be attributed to dissatisfaction with the profit distribution percentage shown in the table or to other factors connected with the liquidity needs of the depositors.

Another reason for the variation in profit distribution to time depositors is the fact that the Nasser Social Bank, the Faisal Islamic Bank of Egypt, and the Faisal Islamic Bank of Sudan distribute dividends to investment account depositors only, while the Dubai Islamic Bank, the Kuwait Finance House, the Jordan Islamic Bank, and the Bahrain Islamic Bank distribute dividends to both savings and investment account depositors. The Faisal Islamic Bank of Egypt is the only bank that pays a quarterly dividend while the other banks pay dividends annually. The Dubai Islamic Bank, the Kuwait Finance House, the Jordan Islamic Bank, and the Bahrain Islamic Bank pay higher dividends on investment accounts committed for longer or unlimited periods of time and lower dividends on savings accounts and investment account deposits committed for a limited period of time. In all cases the amount of dividend paid depends on the length of time the funds are kept by the bank and the profitability of the projects financed by the deposits.

Profit Distribution to Shareholders

Dividends paid to shareholders, as shown in Table 8.15, are slightly higher than those paid to savings account and investment account depositors. The Nasser Social Bank and the Islamic Development Bank did not pay shareholders any dividend because they are government-owned. The Kuwait Finance House shows a substantial increase in dividend payments for the 4 years 1979–1982. Dividends as a percentage of paid-up capital increased from 10 in 1979 to

11.25 percent in 1980, to 30 percent in 1981, and finally to 35 percent in 1982. The 1981 dividend was in the form of stock; 1982 was partly in cash (10 percent) and partly in stock dividends (25 percent). The Faisal Islamic Bank of Sudan shows a 15 percent dividend payment in 1979, 20 percent in 1980, 25 percent in 1981, and 25 percent in 1982. Data available on the other banks show much less dividend distribution to shareholders.

Table 8.15 Islamic banks: dividend distribution percentage of paid-up capital, 1979–1982

	1979	*1980*	*1981*	*1982*
Nasser Social Bank*	0	0	0	0
Dubai Islamic Bank	0	7	8	10
Islamic Development Bank	0	0	0	0
Kuwait Finance House	10	11.25	30*	35†
Faisal Islamic Bank, Egypt‡	8.06	14.17	14.3	15
Faisal Islamic Bank, Sudan	15	20	25	25
Jordan Islamic Bank		0	5	8
Bahrain Islamic Bank‡		6	6.25	12

Sources: Compiled from bank annual reports.
* Stock dividend.
† 10 percent cash dividend and 25 percent stock dividend.
‡ Data as of end of Hijra calendar year.

It is important to state that the dividends paid to depositors and shareholders are the net available earnings after deducting the statutory and the voluntary reserves. The accumulation of the reserves after a long period of time may amount to a substantial sum which benefits the shareholders and not necessarily the savings and investment account depositors because the reserves raise the book value per share which may lead to a higher market value per share. But, this is in conformity with the concept that the longer the depositors and shareholders commit their funds to the bank the higher the return they receive.

Another aspect of profitability of Islamic banks concerns borrowers and profit-sharing clients because profitability is an important factor in the maintenance of deposit accounts and the commitment of funds for a longer period of time. Clients who enter into a Musharakah, Modarabah, or Murabahah arrangement with Islamic banks may expand their operations and develop needs for additional financing and financial services. It is in the interest of both the Islamic bank and the borrower or profit-sharing client to maintain a high level of profitability because they keep each other strong. This relationship is common to all banks and borrowers, but in the case of Islamic banks it is a profound relationship which constitutes the essence of the philosophy of Islamic banking.

PERFORMANCE EVALUATION OF DAR AL-MAAL AL-ISLAMI TRUST

Performance evaluation of the Islamic banks is far from complete without an evaluation of the giant international investment and banking company, Dar Al-Maal Al-Islami Trust (DMI). DMI was established as a trust under the laws of the Commonwealth of Bahamas. DMI's objectives, organizational structure, and operations were discussed in Chapter 6. The purpose of this section is to analyse and evaluate the financial performance of DMI during its first year of operation and to explore specific aspects of its management and future plans. This section covers the following topics related to DMI (1) financial position, (2) investment activities, (3) profitability analysis, (4) expansion programs, and (5) management and human resources. The data provided are based on the first annual report published by the administrator of the DMI Trust SA, Geneva, which covers the activities of DMI Trust from 27 July 1981 to 30 June 1982. The report does not cover the activities of its subsidiary, the Islamic Investment Company (IIC), because the latter is considered as a separate entity despite the fact that DMI benefited from the investment, operating, and marketing systems of the IIC in the Middle East, together with the experienced IIC personnel needed to implement DMI activities.[5]

Financial Position

The financial position of DMI is evaluated by analysis of its assets, capital, capital ratio, and fund utilization ratio. DMI Trust financial statements as of 30 June 1982 show total assets of US$317.1 million, 76 percent of which is in short-term investment, 4 percent in medium- and long-term investment, 18 percent in intangible assets which resulted from the acquisition of IIC which had net operating assets exceeding book value, and 2 percent in fixed assets and current debt. Comparison of current assets with current liabilities results in a current ratio of 37.5, which puts DMI among the most highly liquid business and financial organizations. This high liquidity is attributed mainly to DMI's concentration of assets in short-term investments.

DMI's capital is composed of equity shares issued to the founders and referred to as 'private placement'; equity shares issued to the public and referred to as 'public offerings'; equity shares held in escrow and issued to its subsidiary, IIC; general reserve; and retained earnings. Of the US$1 billion authorized capital, US$307.6 million was paid-up as of 30 June 1982, about 45 percent of which was in private placement, 35 percent was in public offerings, and 20 percent was in acquisition of IIC net operating assets. The total capital amount was US$310.5 million on 30 June 1982, including US$1.2 million of general reserve and US$1.7 million of retained earnings.

The assets of DMI were mainly financed by capital as can be seen from the very high capital to asset ratio, or simply the capital ratio, which stood at

98 percent. This high ratio is expected because IIC, its only subsidiary, is the company through which DMI receives deposits and its financial activities are not consolidated in DMI financial statements. Unfortunately, IIC financial statements were not made available to the authors to make a meaningful deposits and equity analysis. To sum up, the financial position of DMI as of 30 June 1983 was characterized by high liquidity and high capital ratio. The high liquidity is attributed to its short-term investment and the high capital ratio is the result of keeping the accounting of its subsidiary, which accepts deposits, separate from its own.

Investment Activities

DMI invests in foreign currencies, precious metals, and economic development projects in various Islamic countries. On 30 June 1982, the investment portfolio of DMI and other funds covered 25 projects, 12 of which are in Saudi Arabia and the remaining projects in African Islamic countries and Arabian Gulf countries. The Saudi projects include poultry farms, road construction, housing, school construction, shopping centers, prefabricated housing, Islamic clock and watch manufacturing, television studios, supermarkets, steel imports, corn imports, and trucking projects.[8] Projects in the other countries include farm products, a baby food factory, shipping vessels, fishing boats, a bus fleet, and oil and steel imports.

The total short-term investment of DMI amounted to approximately US$240 million and its medium- and long-term investment amounted to US$12.3 million, while the total capital stood at US$310.5 million as of 30 June 1982. Since equity capital is the only source of DMI funds the funds utilization ratio in investment is about 81 percent, which is quite high compared with that of other Islamic banks. This ratio suggests effective use of resources by DMI management, but there is a drawback in the fact that most of the investment is short-term which implies heavy investment in foreign currencies and precious metals. This type of investment does not contribute to the economic development of the Islamic countries. However, the year under consideration is the first year of operation. Long-term projects require a proper evaluation of feasibility studies and other considerations, so the heavy concentration of DMI in short-term investments is justified. The 25 projects included in the DMI portfolio on 30 June 1983, and the effort spent by management in the DMI expansion program, should be considered as major accomplishments.

Profitability Analysis

As the 30 June 1982 financial report is the first report issued by DMI Trust, it is difficult to make any judgment on the profitability of the operations. However, the income statement shows that income for the period 27 July 1981, (the date of formation) to 30 June 1982, is US$29.8 million, derived from three major

sources: income from investment of private placement (founders' shares) through 3 December 1981, income from corporate short-term investments and dividend, and income from Modarabah management of the DMI investment division. Total expenses for the period amounted to US$21.9 million, resulting in US$7.9 million of net profit. The rate of return on DMI assets is 6.9 percent which is a very favorable return compared with that of other Islamic banks. The net profit to revenue ratio reached 27 percent as of the end of the year, which is not as high as that of most Islamic banks. Furthermore, the rate of return on the balance of year-end equity is 2.5 percent, much lower than that of other Islamic privately owned banks. However, these ratios are derived from data related to the first year of operation and no trend is established yet. Consequently, it is difficult to make any judgment on the profitability of the operations.

In an explanatory introduction, the DMI annual report stated that profits averaged 15.9 percent per annum on private placement capital up to 26 July 1981, but profits on public offerings capital up to 31 December 1981 amounted to 13.3 percent per annum. This indicates a high return on capital derived from public and private placements, compared with that of other Islamic banks. Further, the report indicated that the net profit was paid out to holders of the private placement share certificates at the rate of 11.9 percent per annum.[7] The dividend rate paid out by DMI is in line with the average paid out by other Islamic banks.

DMI profit distribution to shareholders is reflected in the increase in market value of the shares, which sold at US$105 per share until December 1981, and increased to US$125 when shareholders began to exchange their equities on 6 December 1982. Within three days, the market value increased to US$133,[8] and in mid-1983 DMI shares were quoted at nearly US$141 per share. The market value for DMI shares is calculated by its economists in Geneva on the basis of the financial standing of its subsidiaries, future prospects, past profits, and general market factors, such as supply and demand for the shares.

Funds received from Modarabah investment certificates are not included in the DMI Trust annual report because they are received through IIC, the DMI subsidiary. These funds are received primarily from Saudi Arabia, UAE, Qatar, and, to a lesser extent, Egypt.[9] The annual return on these certificates varies according to the length of the Modarabah and the currency utilized. The published rate of return on the Modarabah as of 30 April 1983 ranged between 6 percent and 10.9 percent. The special Modarabah certificates issued to financial institutions realized between 6 and 7 percent return as of 30 April 1983.[10]

Expansion Programs

One of the major accomplishments of DMI is its geographical expansion progam. The expansion covers projects in Muslim and non-Muslim countries. During the first year of operations, expansion in the Muslim countries was limited to obtaining the required governmental approvals to gain entry into

these countries, where a number of investment companies, solidarity (insurance) companies, and banks were being established. These companies and banks would be owned 51 percent by DMI and 49 percent by local interests. Cooperation or successful agreements with authorities were reached in 13 Muslim African countries. Similar cooperation agreements were reached in Bahrain, Qatar, UAE, Turkey, Pakistan, Malaysia, and Bangladesh. In Saudi Arabia, requests for establishing investment companies, solidarity companies, and banks were submitted to the government and they are still under consideration.[11]

The DMI expansion effort reached outside the Islamic countries in order to permit the flow of transactions through the DMI network to and from international markets in order to maintain profitability and liquidity in the major international free currencies. Contracts with most of the developed countries resulted in serious difficulties in obtaining licences for DMI banks as this would require a departure from existing banking laws and special tax agreements. The special arrangements would permit users of Islamic financial services to treat profits, which are equivalent to charges in interest financing, as deductible items. The difficulty led DMI to adopt a policy through which the Islamic banks will be considered as private deposit-taking institutions operating according to Islamic principles and not engaging in any local financing activities. The next phase of the expansion would be to apply for limited local licensing to enable an extension of DMI financing activities. So far limited success has been achieved in the Bahamas, Luxemburg, the State of Jersey, the United Kingdom, and Switzerland.[12]

Management and Human Resources

DMI expansion programs impose a considerable strain on management and human resources, requiring detailed planning, stringent cost and budgeting controls, and a highly sophisticated electronic data-processing and management system. DMI has been successful in recruiting international Muslim financial experts and in developing operating systems and plans for its various divisions. In addition to the benefits derived from the existing resources of its IIC subsidiary, DMI collaborated with the International Institute for Islamic Banking and Economics in the Turkish Federated State of Kibris in order to satisfy future human resources requirements. Scholarships were offered by DMI to young Muslim university graduates from eleven countries where DMI is operating or expects to start operations shortly. Another notable accomplishment is the efficiency achieved by using an advanced electronic data-processing system and a modern direct communication system connecting all DMI offices.[13]

In conclusion, DMI results appear to indicate that there is a relationship between profits and size of operations. DMI, as a giant Islamic financial institution, gives the developing Islamic countries and the Islamic religion broad international exposure that is both positive and profitable. DMI has

continued to offer new products on the international market through its extensive network of Islamic financial and investment institutions as it has grown. Using the most modern management and marketing methods, DMI has demonstrated its ability to develop a good public relations image through its rapport with clients and its positive religious identification. Its modern computerized information and reporting services are unique in the Muslim countries and may prove to be very fruitful and profitable in the long-run. Further, the international identity of DMI, its location, and its methods of operation put it in a position to draw on a broader base of qualified personnel, technical experts, and specialized international management and financial consultants.

PROSPECTS FOR THE ISLAMIC BANKS

There is no doubt that Western technological and economic achievements deserve respect and admiration. Many of the factors and change agents that contributed to Western advancement are being introduced or adapted to the conditions that exist in the developing Muslim countries. The introduction of financial techniques, instruments, and institutions is no exception. Muslim countries, which are trying to modernize financial methods and institutions and at the same time preserve their own traditions and beliefs, are faced with the Islamic prohibition on receiving and paying interest. Westerners understand the difficulty once they learn the basic philosophy of Islam.

The emerging Islamic banks and financial institutions are rendering banking and investment services in accordance with the Islamic Shariah which places certain restrictions on financial and business practices. Despite these restrictions, the past performance of Islamic banks shows that the future of Islamic banking is promising. It indicates extraordinary growth in assets, deposits, and capital. Growth and diversification of investment in many economic sectors has proven the viability and contribution of these banks to the development process of the Islamic countries. Most of the Islamic banks offer a variety of banking and social services which, along with investment activities, generate a better than average return on investment. These results have led most of the Islamic banks to branch out locally, nationally, or internationally, providing an indication of the future opportunities and challenges for the Islamic banking system.

Among the opportunities offered to the Islamic banks is the expansion, development, and growth of the economic and business environment of the Muslim states. Also, the banks' religious orientation, and the existence of substantial hoarded funds in the Muslim countries, offer a beneficial means to an end for the system and the religion. These opportunities offer tremendous challenges which could lead to the future success of Islamic banking in the Muslim countries. The need for good management which can cope with problems associated with the potential for success of Islamic banking is obvious. One of the problems is how to keep a balance between the two main goals of Islamic banks, i.e. providing a fair return to depositors and shareholders and

offering social services to the Muslim community. Another problem is the lack of bank marketing activities. Islamic banks need to inform people of their methods and appeal to the religious conscience of savers and entrepreneurs. The need for efficient and effective management and well-trained personnel to provide solutions to these problems cannot be stressed too strongly.

Religious education and compliance with the Shariah on the part of bank personnel and top management are not the only qualifications needed for success in Islamic banking. A good educational background and experience in banking methods, techniques, and services are essential qualifications required of Islamic bank managers. The future of Islamic banking depends on management having a good understanding of the market and financial conditions, evaluation of investment alternatives, risk administration, cash flow, exchange rate fluctuations, tax considerations, and long-term planning strategy.

Conventional banks are well entrenched in the Muslim developing countries and they have highly qualified and experienced managements to cope with banking problems and deal with the Western banking industry. To assume that Islamic banking developments of the 1970s and early 1980s will end Western banking methods, particularly those related to receiving and paying interest, would be unrealistic. The change, however, could come about slowly if Islamic banks can meet the existing challenges and contribute effectively to economic and social development.

There are several indications that Islamic banks can meet the challenges because they have already learned to coexist and even cooperate with conventional banks under government supervision. Government control through central banks and other regulatory bodies gives support to Islamic banks in terms of stability and growth of major sources of funds despite the often restrictive banking controls and regulations. Cooperation and fair competition between conventional banks and Islamic banks are necessary because they allow the consumer to decide if either or both groups will be successful, and whether one of the groups will dominate the market. In this regard, cooperation between the Islamic banks themselves becomes an essential ingredient to their success. The role of the Saudi-based International Association of Islamic Banks is important in this regard. Unification and expansion of banking and investment methods, financial reporting practices, and personnel training and education could be accomplished through the efforts of this association.

In summary, the contribution of Islamic banks so far stems from their ability to mobilize savings and bring them into the development cycle of local and other economies of Muslim countries. Management has proved its point that banking growth and profitability do not have to depend on the practice of receiving and paying interest. However, the prospects for the continuation of success depend to a large extent on management effectiveness in dealing with contemporary banking and business problems, cooperation with conventional banks and central banking authorities, and expanding Islamic business ventures and firms through innovative financing schemes. Moreover, the prospects for the influence of Islamic banks in the Muslim countries depend not only on

their performance but on the support granted by Muslim governments and Muslims all over the world.

DISCUSSION QUESTIONS

8.1 Why is uniformity in the application of accounting policies important in recording assets and liabilities and in calculating profits? State at least three examples to show the lack of uniform application of accounting policies in Islamic banking.

8.2 Why is the selection of accounting methods used in the calculation of revenues and expenses important in Islamic banking?

8.3 What means are used to measure the growth of Islamic banks?

8.4 Exchange rate fluctuations can have a considerable impact on rates of growth as expressed in dollars. Discuss.

8.5 What is the explanation of the steady growth in the number and the average balances of the different deposit accounts at the Dubai Islamic Bank compared with the wide fluctuation in the number and average balances of the different deposit accounts at the Kuwait Finance House?

8.6 The composition of current accounts and savings and time deposit accounts varies substantially between the Islamic banks. Explain the possible reasons for this variation.

8.7 State the several categories of Islamic banks' equity accounts and discuss the implication of the increase in the balances of these accounts.

8.8 What are the contra assets of the Islamic banks and why do they appear below the line on the balance sheet?

8.9 The eight Islamic banks analysed in this chapter experienced a substantial growth in total assets, but they are still small by international standards. Discuss the reasons for this situation.

8.10 State the implications of the debt to equity ratios experienced by the eight Islamic banks analysed in this study.

8.11 The principle of trading on the equity does not apply in Islamic banking. Discuss.

8.12 Define the capital ratio and state the reasons for and implications of its fluctuations.

8.13 The high capital ratio is an important feature of Islamic banking. Why? Also, discuss the implication of this high ratio for the depositors, customers, and shareholders of Islamic banks.

8.14 Which Islamic banks, and for what reason, extend loans? Discuss.

8.15 What is meant by funds utilization ratio? Discuss its use in analysing Islamic bank management efficiency.

8.16 Briefly discuss the order of priorities given by Islamic banks to investment in economic sectors and assess the contribution of these banks to the economic and social development of the Islamic countries.

8.17 Discuss the measures used in assessing the profitability of Islamic banks.

Which of these measures is considered the most reliable indicator of the success of management in meeting the bank objectives?

8.18 Briefly evaluate the performance of DMI and assess its contribution to Islam and the Islamic countries.

8.19 What are the factors contributing to the increase in market price of DMI shares?

8.20 The opportunities available to the Islamic banks offer tremendous challenges to the future success of Islamic banking. Discuss.

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APPENDICES

APPENDIX A

Charter of the Saudi Arabian Monetary Agency

Royal Decree No. 23

23 Jumad Awal 1377
(15 December 1957)

With the help of God Almighty
We, Saud Ibn Abdul Aziz Al-Saud,
King of Saudi Arabia,

having seen Decree No. 30/4/1/1047 issued on 25 Rajab, Decree No. 17/19/2/8792 issued on 17 Ramadan 1374, and Council of Ministers' Resolution No. 103 dated 20 Jumad Awal 1377, and in view of what our Minister of Finance has submitted to us, we ordain the following:

Article 1
The objective of the Saudi Arabian Monetary Agency shall be:

(a) to issue and strengthen the Saudi currency and to stabilize its internal and external value;
(b) to deal with the banking affairs of the Government;
(c) to regulate commercial banks and exchange dealers.

Article 2
The Saudi Arabian Monetary Agency shall not pay nor receive interest but shall only charge certain fees on services rendered to the public and to the Government, in order to cover the Agency's expenditures. Such fees shall be charged in accordance with a regulation passed by the Board of Directors and approved by the Minister of Finance.

The Agency shall not have a capital and shall, therefore, repay to the Government its entire capital.

Article 3
The functions of the Saudi Arabian Monetary Agency in relation to circulation of currency and regulation of commercial banks, shall be:

(a) To stabilize and strengthen the internal and external value of the currency and take measures capable of strengthening the currency's cover. (For that end the Agency

may buy and sell gold and foreign exchange in the market, whenever it deems it necessary and within the limits and conditions approved by the Minister of Finance and National Economy. Such transactions should be conducted with the utmost secrecy.*

(b) To hold and operate monetary reserve funds as separate funds earmarked for monetary purposes only.

(c) To mint and issue the Saudi coins and handle all matters relating thereto, in conformity with Saudi Currency Law No. 24, dated 23 Jamad Awal 1377.

(d) To regulate commercial banks and exchange dealers as may be found appropriate.

Each commercial bank operating in Saudi Arabia shall render to the Monetary Agency a monthly statement of its financial situation in accordance with the specimen forms prepared by the Agency for this purpose. Each bank shall also make available to the Monetary Agency any information required to clarify or integrate the above mentioned statements.

Meanwhile, such bank statements as may be found necessary by the Agency shall not disclose the private accounts of the bank clients.

(e) The commercial banks shall be asked to keep with the Monetary Agency permanent funds in certain proportion with what deposits the bank is holding. Such proportions shall, from time to time, be fixed to suit the prevailing circumstances, in accordance with a resolution passed by the Minister of Finance and moved by the Agency.

Each bank shall strictly adhere to the instructions issued by the Agency in this respect.

Article 4

To deal with the banking affairs of the Government in receiving all revenues and in paying out fund(s), for purposes duly approved by the Government through the Minister of Finance.

Article 5

The Agency shall establish a Research Department to collect and analyse data needed to aid the Government and the Agency in formulating and carrying out financial and economic policies.

Article 6

The Agency shall not undertake any of the following functions:

(a) Acting in any manner which conflicts with the teachings of the Islamic Law. The Agency shall not charge any interest on its receipts and payments.

(b) Receiving private deposits.

(c) Making advances to the Government or to private parties.

(d) Engaging in trade or having an interest in any commercial, industrial, or agricultural enterprise.

(e) Buying or holding fixed property except what the Agency reasonably needs for its operations.

Article 7

The Agency shall be under the control of a Board of Directors which shall be generally responsible for its efficient administration and operation and shall have such powers as

* Addition made to Article 3(a) under Royal Decree No. 10, issued on 1-7-1379.

are necessary and appropriate to that end. The Board of Directors may make such rules and regulations as it may consider necessary; the Board of Directors shall recommend them to the Government through the Minister of Finance.

Article 8

The Agency, in the name 'Saudi Arabian Monetary Agency', shall be a corporation with continuing succession. The Agency is authorized to take such action as may be necessary and appropriate to give effect to this charter, including, but without thereby limiting its authority, authority to make contracts, to acquire and hold and pledge assets, and to incur such liabilities as are necessary and appropriate to the conduct of its operations.

Article 9

The Saudi Arabian Monetary Agency's Board of Directors shall consist of:

(a) A President, who shall also be the Governor.
(b) Deputy Governor.
(c) Three members, non-government officials, who shall be conversant with financial and commercial affairs.

The Governor and members of the Board shall be appointed for 5 years by a Royal Decree, in accordance with the nomination of the Minister of Finance and the approval of the Council of Ministers. They shall not be removed from office except by a Royal Decree which shall be issued the same way. The Board of Directors shall meet at the call of the President, or Vice-President in the absence of the former. Meetings shall be held at least once per month. In the event of the absence of the Governor, the Deputy Governor shall preside over the Board.

The resolutions of the Board shall be passed by a minimum majority of three votes, and in the case of an equal division of votes, the President shall have a casting vote.

Resolutions of the Board shall be transmitted to the Minister of Finance [and] immediately they shall be issued.

Article 10

The Governor shall be responsible for the efficient operation of the Agency and shall represent it before courts. The Deputy Governor shall be appointed by a Royal Decree on the nomination of the Minister of Finance and the approval of the Council of Ministers, in order to act for the Governor in the event of the latter's absence, whose powers shall then be vested in the Deputy Governor who shall also be removed from office by a Royal Decree. The remunerations of the Governor, Deputy Governor, and Members of the Board shall be fixed by a Resolution of the Council of Ministers in accordance with the recommendations of the Minister of Finance. The appointment of the remaining staff of the Agency, other than the Governor and the Deputy Governor, their promotion and dismissal, shall be dealt with by the Governor under the provisions of a regulation approved by the Board of Directors and generally based on similar rules and regulations pertaining to Saudi and foreign government employees. The Governor shall also fix the salaries of these employees, their wages, the duration and terms of their services, their duties and responsibilities in conformity with the said regulations.

Article 11

The Agency shall render to the Government, through the Minister of Finance, a copy of the half-monthly and annual statements published in the official bulletin, as provided by

Article 11 of Royal Decree No. 24 dated 23 Jumad Awal 1377, in regard to the Saudi Arabian currency.

Article 12
Any bank or exchange dealer who fails to furnish the Agency with the information specified in para. (d), Article 3, or fails to keep with the Agency the deposit mentioned in para. (e) of the same article in the proportion suggested by the Minister of Finance, shall sustain a maximum punishment of SR 10 000. In the event of recidivation to such acts, the Government, in addition to the above mentioned punishment, shall temporarily cease the operations of the bank and close it down.

Article 13
This Statute shall replace the previous Statute of the Agency together with the entire amendments inserted therein and shall cancel each provision not conforming with its articles.

Article 14
The Prime Minister and the Minister of Finance shall put this Statute into effect.

APPENDIX B

The Banking Control Law

Promulgated by Royal Decree No. M/5 of 22/2/1386 AH

Article 1

In this Law the following expressions shall have the definitions specified in this article:

(a) 'Bank' means any natural or juristic person practising basically any of the banking business in the Kingdom.
(b) 'Banking business' means the business of receiving money on current or fixed deposit account, opening of current accounts, opening of letters of credit, issuance of letters of guarantee, payment and collection of cheques, orders, or payment orders and similar other papers of value, discounting of bills, promissory notes and other commercial papers, foreign exchange business and other banking business.
(c) 'National Bank' means a bank, the head office and branches of which are situated in the Kingdom.
(d) 'Foreign Bank' means a bank with branches in the Kingdom and its head office outside it.
(e) 'Agency' means the Saudi Arabian Monetary Agency.
(f) 'Invested capital' means the capital assigned by a foreign bank for the use of its branches in the Kingdom.

Article 2

No person, natural or juristic, unlicensed in accordance with the provisions of this Law, shall carry on basically any of the banking business. However:

(a) Juristic persons licensed in accordance with another law or special decree to carry on banking business within the limits of their objects may practise such banking business.
(b) Licensed money-changers may practise basically exchange of currency in the form of notes and coins, but no other banking business.

Article 3

All applications for the grant of licences to carry on banking business in the Kingdom shall be addressed to the Agency which will study the applications after obtaining all the necessary information and submit its recommendations to the Minister of Finance and National Economy.

The licence for a National Bank shall stipulate the following:

(1) It shall be a Saudi Joint Stock Company.
(2) The paid-up capital shall not be less than Rls. 2.5 million and all subscription towards share capital shall be payable in cash.
(3) The promoters and directors shall be persons of good reputation.
(4) The memorandum and articles of association shall be acceptable to the Minister of Finance and National Economy.

In the case of a Foreign Bank wishing to set up a branch or branches in the Kingdom, the grant of a licence shall be subject to such conditions as the Council of Ministers may stipulate upon the suggestion of the Minister of Finance and National Economy. The licence shall in all cases be issued by the Minister of Finance and National Economy after the approval of the Council of Ministers.

Article 4
As an exception to the provisions of the previous Article, the licences or authorizations previously issued to the persons carrying on banking business in the Kingdom and effective at the time of promulgation of this Law, shall continue to be recognized.

The Agency may, however, call for such documents and information from persons as it may deem necessary. The Agency with the approval of the Council of Ministers may call upon them to comply with all or any of the provisions of Article 3 of this Law within such period as it may fix.

Article 5
Any person not authorized basically to carry on banking business in the Kingdom is not allowed to use the word 'Bank' or its synonyms, or any similar expression in any language, on his papers or printed matter, or in his commercial address or his name or in his advertisements.

Article 6
The deposit liabilities of a Bank shall not exceed fifteen times its reserves and paid-up or invested capital. If the deposit liabilities exceed this limit, the Bank must, within one month of the date of submission of the statement referred to in para. 1 of Article 15, either increase its capital and reserves to the prescribed limit or deposit fifty percent of the excess with the Agency.

Article 7
Every Bank shall maintain with the Agency at all times a statutory deposit of a sum not less than fifteen percent of its deposit liabilities. The Agency may, if it deems it to be in the public interest, vary the aforesaid percentage provided that it shall not be reduced below 10 percent nor increased to more than 17.5 percent. The Agency may, however, vary these two limits with the approval of the Minister of Finance and National Economy.

In addition to the statutory deposit provided for in the previous paragraph, every bank shall maintain a liquid reserve of not less than 15 percent of its deposit liabilities. Such reserve shall be in cash, gold, or assets which can be converted into cash within a period not exceeding 30 days. The Agency may, if deemed necessary, increase the aforesaid percentage up to twenty percent.

Article 8
No bank shall grant a loan or extend a credit facility or give a guarantee or incur any other financial liability with respect to any natural or juristic person for amounts aggregating more than 25 percent of the Bank's reserves and paid-up or invested capital. The Agency may, in the public interest and subject to such conditions as it may impose, increase this percentage up to 50 percent.

The provisions of the above paragraph do not apply to transactions between banks or between head offices and their branches or between these branches.

Article 9
No bank shall undertake the following transactions:

(1) Granting a loan or extending credit facilities or issuing a guarantee or incurring any other financial liability on the security of its own shares.
(2) Granting without security a loan or credit facilities, or issuing a guarantee, or incurring any other financial liability in respect of:
    (a) Members of its Board of Directors or its Auditors.
    (b) Establishments not taking the form of joint-stock companies in which any of its Directors or Auditors is a partner or is a manager or has a direct financial interest.
    (c) Persons or establishments not taking the form of joint-stock companies in cases where any of the Bank's Directors or Auditors is a guarantor.
(3) Granting without security a loan or a credit facility or giving a guarantee or incurring any other financial liability in favor of any of its officials or employees for amounts exceeding four months salary of any such concerned person.

Any bank director or auditor or manager who contravenes paras 2 and 3 of this Article, shall be considered as having resigned his position.

Article 10
No Bank shall undertake any of the following activities:

(1) Engage, whether for its own account or on a commission basis, in the wholesale or retail trade including the import or export trade.
(2) Have any direct interest, whether as stock-holder, partner, owner, or otherwise, in any commercial, industrial, agricultural, or other undertaking exceeding the limits referred to in para. 4 of this Article, except when such interest results from the satisfaction of debts due to the bank, provided also that all such interest shall be disposed of within a period of two years or within any such longer period as may be determined in consultation with the Agency.
(3) Purchase, without the approval of the Agency, stocks and shares of any bank conducting its business in the Kingdom.
(4) Own stocks of any other joint-stock company incorporated in the Kingdom, in excess of ten percent of the paid-up capital of such a company, provided also that the nominal value of these shares shall not exceed twenty percent of the Bank's paid-up capital and reserves; the above limits may, when necessary, be increased by the Agency.
(5) Acquire or lease real estate except in so far as may be necessary for the purpose of

conducting its banking business, housing of its employees or for their recreation, or in satisfaction of debts due to the Bank.

In cases where a bank acquires real estate in satisfaction of debts due to it and such real estate is not necessary for the Bank's own banking business or housing of its employees or for their recreation, it shall dispose of it within three years of its acquisition or, in exceptional and justifiable circumstances, within such period or periods as may be approved by the Agency and subject to such conditions as it may deem fit to prescribe.

As an exception to the provisions of para. 5 of this Article, the Bank may, in special and justifiable circumstances and with the approval of the Agency, acquire real estate, the value of which shall not exceed 20 percent of its paid-up capital and reserve.

Article 11

Banks are precluded from undertaking any of the following operations except after the written approval of the Agency and according to the conditions it prescribes.

(a) Altering the composition of their paid-up or invested capital.
(b) Entering into any scheme of amalgamation or participation in the business of another bank or another establishment carrying on banking business.
(c) Acquiring shares in a company established outside the Kingdom.
(d) Ceasing to carry on banking business. In such a case, the Agency must, before agreeing to this cessation, ascertain that the Bank has made necessary arrangements to safeguard the rights of the depositors.
(e) Opening branches or other offices in the Kingdom and also opening of branches or other offices by national banks outside the Kingdom. Before granting this written licence provided for under this paragraph, the Agency should get the approval of the Minister of Finance and National Economy.

Article 12

No person shall be a director of more than one bank.

No person in the following cases shall be elected as a director or shall become manager of any bank without prior written approval of the Agency:

(a) If he occupied a similar position in a banking concern that was wound up, even if the liquidation has been made before the promulgation of this law. Such approval shall not be given by the Agency until it becomes clear that the person concerned was not responsible for that liquidation.
(b) If he was removed from a similar post in any banking establishment, even if such removal was before the promulgation of this law. The approval of the Agency shall in this case be based on acceptable reasons.

Any director or manager of a bank who is adjudicated bankrupt or convicted of a moral offence shall be considered as having resigned his post.

Article 13

Every bank shall before declaring distribution of any profits, transfer a sum equal to not less than 25 percent of its net profits, to the statutory reserve, until the amount of that reserve equals as a minimum the paid-up capital.

No Bank shall pay dividends or remit any part of its profits abroad, until its aggregate foundation expenditures and losses incurred have completely been written off, and after

deducting not less than 10% of the value of capitalized expenditures until all these expenditures have been completely written off.*

Any action taken to declare or pay dividends in contravention of the provisions of this article shall be considered null and void.

Article 14

Every Bank shall appoint annually two auditors from amongst the approved list of auditors registered with the Ministry of Commerce and Industry. The Auditors shall submit a report on the balance sheet and profit and loss account. This report shall include whether in the auditors' opinion the Bank's balance-sheet duly and correctly represents its financial position and the extent of their satisfaction with any explanations or information they may have requested from the Bank's manager or other staff.

As regards banks taking the form of a company, the report referred to in the above paragraph shall be read together with the annual report of the Bank management in the General Meeting which must be held within the six months following the end of the Bank's financial year. The Bank management should send copies of these two reports to the Agency.

The provisions of the first para of this Article shall apply to foreign banks in respect of their branches operating in the Kingdom. They should send a copy of the Auditors' report to the Agency.

Article 15

Every bank shall furnish the Agency by the end of the following month with a consolidated monthly statement of its financial position relating to the previous month which shall be true and correct and be in the form prescribed by the Agency. Every bank shall also furnish the Monetary Agency within six months of the close of its financial year with a copy of its annual balance sheet and profit and loss account certified by its auditors in the form prescribed by the Agency.

Article 16

The Monetary Agency may, with the approval of the Minister of Finance and National Economy, issue general rules regarding the following matters:

(1) The maximum limits of total loans that can be extended by a bank or banks.
(2) The prohibition or limitation of specified categories of loans or other transactions.
(3) Fixing the terms and conditions which banks should take into consideration when carrying out certain types of transactions for their customers.
(4) The cash margins to be obtained by banks against specified categories of credits or guarantees.
(5) The minimum ratio to be observed between the limits for loans and the collateral for such loans.
(6) Fixing the assets to be maintained by each bank within the Kingdom. Such assets should not fall below a certain percentage of the bank's deposit liabilities which shall be fixed by the Agency from time to time.

The Agency may, from time to time, issue decisions concerning the following:

(1) Definition of the expression 'deposit liabilities' referred to in this law.
(2) Determination of bank holidays and business hours in banks.

* Amended in accordance with Royal Decree No. M/2 dated 6-1-1391.

Article 17
The Agency may, at any time, require any bank to supply it, within a time limit it will specify and in the manner it will prescribe, with Any information that it deems necessary for ensuring the realization of the purposes of this Law.

Article 18
The Agency may, with the approval of the Minister of Finance and National Economy, cause an inspection to be made of the books and accounts of any bank, either by the Agency's own staff or by outside Auditors assigned by it. The examination of the bank's books and accounts should take place in the bank's premises. In such a case the Bank staff must produce all the required books of accounts and other documents in their custody or within their authority and must furnish any information they have relating to the bank.

Article 19
Any person who comes into possession of information during the performance of his duties in the implementation of this Law, is not allowed to disclose such information or to make use of it in any manner.

Article 20
The Agency shall periodically publish combined statements of the principal data contained in the returns mentioned in Article 15.

Article 21
The Minister of Finance and National Economy, in exceptional circumstances, and with the prior approval of the Council of Ministers, may exempt any bank from any provision of this Law or from the regulations issued in execution thereof for a limited period and subject to such other conditions as may be laid down in each case.

Article 22
If the Agency finds that a bank has failed to comply with the provisions of this Law, or with the provisions of any regulations issued under this Law, or if a bank adopts a policy that might seriously affect its solvency or liquidity, it may, with the approval of the Minister of Finance and National economy, take one or more of the following measures:

(a) Appoint one or more advisers to advise the bank in the conduct of its business.
(b) Order the suspension or removal of any director or officer of the bank.
(c) Limit or suspend the granting of credits or the acceptance of deposits.
(d) Require the bank to take such other steps as it may consider necessary.

If the Agency finds that a bank persistently contravenes the provisions of this Law or the decisions or regulations made thereunder, it may call upon such a bank to submit its reasons for the contravention, accompanied by its proposals to rectify the position within a stated period. If the Agency is of the opinion that such proposals are not sufficient for their purpose or if the bank fails to implement an agreed or prescribed course of action within the stated period, the Minister of Finance and National Economy may, subject to the approval of the Council of Ministers, revoke the licence of the said bank.

Article 23

(1) Any person who contravenes the provisions of para. 1 of Article 2, Article 5 and items a, b and c of para. 1 of Article 11, Article 12 and Article 18, shall be liable to imprisonment for a term not exceeding two years and to a fine not exceeding Rls. 5000 for every day the offence continues or to either of these penalties.
(2) Any person who contravenes the provisions of Article 19, shall be liable to imprisonment for a term not exceeding two years and to a fine not exceeding Rls. 20 000, or to either of these penalties.
(3) Any person who contravenes the provisions of Articles 8, 9, and 10, shall be liable to imprisonment for a term not exceeding six months and to a fine not exceeding Rls. 10 000, or to either of these penalties.
(4) Any person who contravenes the provisions of Articles 7, 14, and 15 shall be liable to a fine not exceeding Rls. 500 for every day the contravention continues.
(5) Any person who contravenes any other provision of this Law or the Regulations and decisions issued in execution thereof shall be liable to a fine not exceeding Rls. 5000.
(6) In the event that offences punishable according to paras 2, 3, and 5 of this Article are committed by the same person for one purpose and provided that such offences are interrelated as to object and timing they are to be considered as one offence punishable by one penalty.

Article 24

The Chairman, the Managing Director, the Directors, Head Office Manager and Branch Manager shall be responsible, each within his own jurisdiction, for any contravention of this Law or the decisions and rules issued for its execution.

Article 25

The Minister of Finance and National Economy shall appoint a committee of three persons from outside the Agency and specify the conditions and measures to be observed in adjudging contraventions punishable under this Law at the request of the Agency.

Article 26

The Vice-President of the Council of Ministers and the Minister of Finance shall put this Law into effect and it shall come into force from the date of its publication.

APPENDIX C

Foreign Capital Investment Law

Promulgated by Royal Decree No. M/4 of 2/2/1399 AH

Article 1
For the purposes of this Law, Foreign Capital shall mean any coins, currency notes, securities, machinery, equipment, spare parts, raw materials, products, transportation facilities, and intangible rights, such as patents, trade-marks, and similar assets, where such capital is owned either by a natural person who is not of Saudi Arabian nationality or by a corporate person whose capital share-holders are not all of Saudi Arabian nationality.

Article 2
Without violation to the provisions of other laws in force, Foreign Capital investment requires a Licence issued by the Minister of Industry and Electricity following the recommendation of the Foreign Investment Committee, provided that the following two conditions are fulfilled:

(a) The Foreign Capital shall be invested in development projects which, for the purposes of this Law, do not include petroleum and mineral extraction projects.
(b) The investment shall be accompanied by foreign technical know-how and expertise.

Article 3
Development projects shall be determined by a resolution from the Minister of Industry and Electricity following the recommendations of the Foreign Investment Committee within the guidelines of the development plan.

Article 4
A committee called the 'Foreign Capital Investment Committee' shall be set up in the Ministry of Industry and Electricity. The committee shall be composed of the following members:

- The Deputy Minister of Industry and Electricity, or his substitute (in the event of his absence), to act as Chairman.
- A representative from the Ministry of Planning.
- A representative from the Ministry of Finance and National Economy.
- A representative from the Ministry of Agriculture and Water.

- A representative from the Ministry of Petroleum and Mineral Resources.
- A representative from the Ministry of Commerce.

None of the representatives for the membership of the committee shall rank lower than the tenth grade. The Director of the Foreign Investment Bureau at the Ministry of Industry and Electricity shall act as Secretary to the Committee and the Minister of Industry and Electricity shall appoint a legal advisor for the committee. The committee may, at its own discretion, call on certain experts during the discussion of certain subjects, but these experts shall have no voting right. The meetings of the committee shall be valid only if attended by at least four members including the Chairman; and the committee's deliberations shall be confidential. The resolutions of the committee shall be adopted by a majority of attending votes. In case of a tie, the Chairman shall have the casting vote. However, the committee's resolutions shall not become final unless approved and ratified by the Minister of Industry and Electricity.

Article 5
The Committee, referred to in Article 4, shall have the following tasks:

(a) To propose the projects that will be classified as development projects.
(b) To consider Foreign Investment applications.
(c) To examine any complaints or claims submitted by foreign investors or other parties concerned arising out of questions governed by this Law; and to submit its recommendations on these matters to the competent authorities.
(d) To recommend penalties which, in the opinion of the committee, should be imposed on any project violating the provisions of this Law.
(e) To draft rules of procedures for the implementation of this Law.
(f) To consider matters, referred to the Committee by the Minister of Industry and Electricity, concerning the provisions of this Law.

Article 6
The Foreign Capital Investment Bureau at the Ministry of Industry and Electricity shall supply all necessary information, clarifications, and statistical data to any foreign applicant who desires to invest capital in the Kingdom. The bureau shall also facilitate and complete necessary formalities pertaining to licensed Foreign Investments. The Ministry of Foreign Affairs and the Ministry of Interior shall grant to investors licensed in accordance with this Law, their employees and workers entry and exit visas and residence permits.

Article 7
Foreign Capital which has fulfilled the conditions provided for in this Law shall have the following privileges:

(a) Privileges enjoyed by national capital under the Law for the Protection and Promotion of National Industries in respect to industrial projects only.
(b) Exemption from Income Tax and Company Tax for a period of ten years to any industrial or agricultural projects having Foreign Capital. Other projects shall be exempted from such taxes for a period of five years.

The projects which enjoy exemption at the time of the implementation of this Law shall benefit from the provisions of exemption mentioned in this sub-clause.

The prerequisite for a tax exemption is that Saudi capital shall not be less than

twenty five percent of the total capital of the project and that such a percentage shall be maintained throughout the period of exemption.

For industrial projects the period of exemption shall start as of the date of the commencement of production and for other projects from the start of activities.

This last sub-clause may be amended by a resolution by the Council of Ministers.

(c) Ownership of any real estate required by Foreign Investment projects in accordance with the Law for Non-Saudi Ownership of Real Estate.

Article 8

Without violation to the provisions herein, projects benefiting from the provisions of this Law shall be subject to the Labor Law, the Law for Social Insurance, and other Laws in force in the Kingdom.

Article 9

The provisions of this Law shall not apply to the projects in which Foreign Capital is invested in the following cases:

(a) If the project was legally in existence prior to the implementation of this Law. However, the operation of such projects or any increase in their capital shall be subject to the provisions of this Law.

(b) If the project is authorized to operate in the Kingdom by virtue of special laws or agreements.

Article 10

Any project licensed under this Law, violating the provisions herein, shall be warned by the Minister of Industry and Electricity to abide by these provisions within a period to be specified by the Minister. Should such project not comply with the said warning, the Minister may, following a recommendation by the Foreign Investment Committee, withdraw the licence granted to that project or order its final liquidation and closure.

Following a recommendation by the said committee, the Minister may, in lieu of withdrawing the licence, deprive such project of all or part of the privileges provided under this Law.

However, parties concerned may appeal to the Board of Grievances, against the Minister's decision imposing such penalty, within thirty days as of the date on which the decision has been officially notified.

The verdict of the Board of Grievances shall be final and binding.

Article 11

The rules of procedure for the implementation of this Law shall be issued by the Minister of Industry and Electricity and shall be published in the *Official Gazette*.

Article 12

This Law shall be published in the *Official Gazette* and shall become effective thirty days after the date of its publication. The Foreign Capital Investment Law promulgated by the Royal Decree No. 35 dated 11/10/1383 AH shall be superseded as of the date this Law is put into effect.

(I) Procedure for Establishing Projects

(1) The prospective investor should write to the Ministry of Industry and Electricity for

a permission of the Ministry to initiate a feasibility study on the proposed project. The latter should contain the following information:

(a) Type of industrial activity proposed.
(b) Approximate output capacity of the project.
(c) Location of the project.
(d) Name and address of the investor, including telephone/telex number, if available.

(2) The above letter of the prospective investor will be studied by the Grace-Period Section of the Industrial Licensing Department to judge the supply and demand position for both the product proposed and substitute products. If the study shows a need for the establishment of the proposed industrial project, the prospective investor will receive from the Ministry permission for a grace period of 6 months, within which (subject to No. 3 below), he will submit to the Ministry the following:

(a) Projects with proposed capital investment between one and ten millions Saudi Riyals:
The prescribed 'Licence Application Form' should be completed, wherein the capital investment should consist of the fixed capital plus the quarterly cost of raw materials, salaries and wages, and runnings costs.
(b) Projects with proposed capital investment of more than ten million Saudi Riyals:
In addition to (a) above, the following items are required:
- Economic study of the project (market, investment required, production cost, break-even point, return on investment, and cash flow).
- Technical study of the project (method of production, types of equipment, raw materials, etc.).

(3) If the prospective investor finds that the grace period of six months is not sufficient to complete the feasibility study he may, at the end of this period, be granted upon his request an extension of period not more than three months. The extension is granted to him if he provides reasonable justification to the Ministry.
(4) At the end of the grace period, or when the study is finalized, an application for Licence should be made on the prescribed Licence Application Form, which is available with Foreign Capital Investment Bureau. The completed application form and the relevant studies should be submitted to the Foreign Capital Investment Bureau. These documents should be submitted under a covering letter showing the date and number of Ministry's permission referred to in (2) or (3) above.
(5) Grace periods are granted only to businessmen and investors in general. The Ministry does not grant grace periods to consulting firms or any intermediaries.
(6) Expansions of licensed projects do not require the application for grace periods. But the owner of the licensed project will have to submit an Expansion Application Form together with a written justification showing increased market demands and potentialities.
(7) Incomplete applications will not be accepted by the Foreign Investment Bureau.
(8) The Foreign Investment Bureau will forward the Licence application/documents to the Industrial Licensing Department for evaluation. On receipt of the evaluation Report, the documents would be placed before the Foreign Investment Committee which will, in turn, submit its recommendation to the Minister of Industry and Electricity.

(9) On approval, the Minister will sign the Licence. The original Licence will be sent to the applicant, and a copy would be provided to the Ministry of Commerce (Department for Companies and Registration) where action for commercial registration would be processed as and when the Licensee submits to them all the required documents including the Articles of Association, etc.

(10) Licensed industrial projects will get the benefit of all the privileges provided under Industrial Protection and Encouragement Regulations.

(11) Six months after the issue of the Industrial Licence, its duration may be extended by three months provided it is proved that concrete steps have already been taken towards the establishment of the project; this period can be extended further by three months if the licensee could satisfy the Ministry that lack of progress is due to circumstances beyond his control. These circumstances do not, however, include the inability of the licensee to obtain a loan from the Saudi Industrial Development Fund.

(12) The Industrial Licence will be cancelled by the Minister following a recommendation of Foreign Investment Committee, in the cases given below:

(a) Failure of the licencee to start the establishment of the project within the first year of issuing the Industrial Licence. The same applies to the expansion's Licences.

(b) Inability of the licencee to provide the Ministry with acceptable reasons/evidence for the lack of progress in setting-up the licensed project.

(II) Procedure for Establishing Non-Industrial Projects

(1) The prescribed Application Forms for non-industrial Projects (Contracting, Maintenance, Technical and Other Services, and Transportation projects) are available with the Foreign Capital Investment Bureau in the Ministry of Industry and Electricity.

(2) The completed Application Form, together with all the required documents listed in the application form, should be submitted to the Foreign Investment Bureau.

(3) The Foreign Investment Bureau will evaluate the proposed project and place its evaluation report before the Foreign Investment Committee.

(4) The Foreign Investment Committee, in turn, would examine the evaluation report/documents and would submit its findings/recommendations to the Minister of Industry and Electricity.

(5) In case the proposed project's application is approved by the Ministry, a Licence will be issued, signed by the Minister.

(6) The original Licence will be sent to the applicant and a copy would be forwarded to the Minister of Commerce (Department of Companies and Registration), where action for commercial registration would be processed as and when the Licencee submits to them all the required documents including Articles of Association.

(7) If the licensed project is not established within the stipulated period of 6 months, an extension of the period could be granted by the Ministry upon request, provided the licencee shows reasonable justification for not implementing the licensed project. In case the project is not established within the given period, the Licence will be cancelled by the Minister upon the recommendation of the Foreign Investment Committee.

APPENDIX D

Specialized Credit (Funding) Agencies and Banks*

Saudi Arabian Agricultural Bank
Established in 1963, based in Riyadh, and with a capital of SR 789 million ($223 million) in 1975–1976. The SAAB provides loans and credit facilities for the development of agricultural-related activities.

Public Investment Fund
Established in 1971, and based in Riyadh. Capital of SR 7400 million ($2,093 million) in 1976. Fulfils the medium- and long-term financing requirements of the General Petroleum and Minerals Organization (Petromin) and SAUDIA (Saudi Arabian Airlines), and also undertakes equity participation in domestic industrial enterprises. The equity thus acquired will be sold later to low-income Saudis.

Saudi Credit Bank
Established in 1973. Based in Riyadh. Provides interest-free loans to low-income Saudi nationals for specified socio-economic purposes.

Credit Fund for Contractors
Established in 1974. Based in Riyadh. Capital of SR 50 million. Provides interest-free loans to Saudi contractors for financing direct purchase of required materials, and credit facilities for short- or medium-term loans.

Saudi Industrial Development Fund
Established in 1974. Based in Riyadh. Capital SR 3,000 million ($849 million) plus SR 1250 million ($354 million) for electricity projects. Provides medium- or long-term loans at 2 percent to new or existing industries.

Real Estate Development Fund

Established 1974. Based in Riyadh. Capital SR 3,000 million ($849 million). Provides loans to individuals and organizations for private or commercial real estate projects for up to 70 percent of construction costs.

* The following information has been taken from 'Saudi Arabia', special report, *Middle East Economic Digest*, August 1978, p. 47.

Saudi Investment Banking Corporation
Established 1976. Based in Jiddah. Capital of SR 30 million ($8.5 million). Provides medium- and long-term loans to businesses and individuals, particularly for financing new projects in agriculture, industry, and other fields. Managed for the first five years by Chase Manhattan Banking Corporation which holds 20 percent of the capital through its wholly-owned subsidiary, Chase Manhattan Overseas Capital Corporation. The Industrial Bank of Japan, J. Henry Schroder Wagg & Company of the United Kingdom, and Commerzbank of West Germany hold 5 percent each. Another 29 percent is held by the National Commercial Bank, Riyadh Bank, Bank al-Jazira and the General Organization for Social Insurance. Public subscribers hold 36 percent.

General Organization for Social Insurance
Established in 1969. Based in Riyadh. GOSI invests its funds in profitable public limited companies and thus has recently become a source of industrial finance.

Saudi International Bank
Established in 1975. Based in London. Capital $92 million. Develops business relationships with companies trading and investing in the Middle East, especially in Saudi Arabia. Principal shareholder in the Saudi Arabian Monetary Agency (SAMA) with 50 percent. Other shareholders are the National Commercial Bank (2.5 percent), Riyadh Bank (2.5 percent), Morgan Guaranty Trust Company of New York (29 percent), and, with 5 percent each, the Bank of Tokyo, Banque Nationale de Paris, Deutsche Bank, National Westminster Bank and the Union Bank of Switzerland.

APPENDIX E

Saudi Fiscal, Hijra and Gregorian Years

*Saudi fiscal year**	*Starts on*	*Hijra year†*	*Starts on*
1390–1391	2 September 1970	1390	9 March 1970
1391–1392	22 August 1971	1391	27 February 1971
1392–1393	10 August 1972	1392	16 February 1972
1393–1394	30 July 1973	1393	4 February 1973
1394–1395	20 July 1974	1394	24 January 1974
1395–1396	10 July 1975	1395	13 January 1975
1396–1397	28 June 1976	1396	2 January 1976
1397–1398	17 June 1977	1397	22 December 1976
1398–1399	6 June 1978	1398	11 December 1977
1399–1400	27 May 1979	1399	1 December 1978
1400–1401	15 May 1980	1400	20 November 1979
1401–1402	5 May 1981	1401	9 November 1980
1402–1403	24 April 1982	1402	28 October 1981
1403–1404	14 April 1983	1403	18 October 1982
1404–1405	4 April 1984	1404	8 October 1983

* Saudi fiscal year starts 1 Rajab and ends 30 Jumad II.

† Hijra months are: Muharram, Safar, Rabi I, Rabi II, Jumad I, Jumad II, Rajab, Shaban, Ramadhan, Shawwal, Dhul-Qi'dah, and Dhul-Hijjah.
Gregorian months are: January, February, March, April, May, June, July, August, September, October, November, and December.

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The Saudi Financial System

In the context of Western and Islamic finance

Adnan M. Abdeen *and* Dale N. Shook, *both of the University of Petroleum and Minerals, Dhahran, Saudi Arabia*

All those with interests in Middle East economics or international business, as well as students of finance and business in the Arabic world, will value this comprehensive introduction to the Saudi financial system. The authors examine the evolution of the Saudi financial system, its economic and commercial context, and its institutions and processes. Western influences on Saudi finance, and the role of Saudi finance in Middle Eastern, Third World, and wider international investment and development are discussed and assessed.

A major section and feature of this book is the discussion of Islamic banking, financial principles and developments, and of the service, performance and prospects for Islamic banks, which are so central to the Saudi financial system and of growing importance internationally.

Contents: **Part I Introduction:** 1 Evolution of the Saudi Financial System; **Part II Money and Capital Markets:** 2 Monetary Authority and Control; 3 Money Market Institutions: I; 4 Money Market Institutions: II; 5 Saudi Capital Markets; **Part III Islamic Banks:** 6 The Evolution of Islamic Banking; 7 Islamic Banks: Operating Methods and Services; 8 Islamic Banks: Past Performance and Future Prospects; **Appendices:** A. Charter of the Saudi Arabian Monetary Agency; B. The Banking Control Law; C. Foreign Capital Investment Law; D. Specialized Credit (Funding) Agencies and Banks; E. Saudi Fiscal, Hijra, and Gregorian Years; Index.

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